

# ASSESS, ASSURE AND INFORM

## IMPROVING AUDIT QUALITY AND EFFECTIVENESS

REPORT OF THE INDEPENDENT REVIEW INTO THE  
QUALITY AND EFFECTIVENESS OF AUDIT

SIR DONALD BRYDON CBE  
LONDON  
DECEMBER 2019



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Printed on paper containing 75% recycled fibre content minimum

Printed in the UK by the APS Group on behalf of the Controller of Her Majesty's Stationery Office

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# 1. Preface

**1.1** Language matters. How audit is described influences how it is conducted and how users respond to it. It starts with a clear description (certainly from auditors) that it is for directors to communicate about their company and, within limits, for auditors to confirm what is communicated. Michael Power titled his book in 1997 *The Audit Society – Rituals of Verification*<sup>1</sup>. The quality and effectiveness of audit has become an increasingly contested issue, with the result that this Review has been commissioned. Some consider that audit is good enough but the starting place of this Report is that it is not.

**1.2** At a time when information is everywhere and there is no obligation on users of the internet to be truthful, it matters even more that shareholders, and others, can trust what directors are communicating. Auditors have a unique advantage in having the right to see everything that goes on in a company and to assess whether that trust is deserved.

**1.3** There has been a slow evolution, since the 1970s, in the role of audit from being just a periodic external check on the accuracy of financial reporting towards a value adding function, but this has further to go.<sup>2</sup> In hiding behind the need only to confirm and verify, many auditors have failed to grasp the opportunity to make their reports more informative. Many do take this opportunity in private, communicating well beyond the narrow confines of auditing standards when reporting to audit committees, but not to shareholders or other stakeholders.

**1.4** There needs to be a fundamental shift in definition and approach to ensure that all appropriate opportunities are taken for the auditor to inform as well as to confirm and verify. This will mean sometimes going beyond the information contained in the statements of the directors. With this change in mindset, and appropriate structures and principles, combined with more focused training and better user engagement, I consider that audit can serve a much more useful purpose.

**1.5** Audit is not broken but it has lost its way and all the actors in the audit process bear some measure of responsibility. It is particularly difficult to analyse because it is a credence good – i.e. one where its true quality is unknown at the point of use. It has been stated that “one important implication of viewing auditing as a credence good is that the quality of individual

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<sup>1</sup> Michael Power, *The Audit Society – Rituals of Verification*; Oxford University Press (1997)

<sup>2</sup> David Gwilliam, *Audit methodology, risk management and non-audit services: what can we learn from the recent past and what lies ahead?*; ICAEW Briefing (May 2003) (based on a P D Leake Lecture at Chartered Accountants' Hall, 14 May 2003). Available: <https://www.icaew.com/-/media/corporate/files/technical/research-and-academics/publications-and-projects/audit-and-assurance-publications/briefing-05-03-audit-methodology-risk-management-and-non-audit-services.ashx>

engagements can vary due to idiosyncratic aspects of the client.”<sup>3</sup> Good audit, however, will respond to such idiosyncrasies and should ultimately lead to a lower cost of capital, and lower costs from unnecessary corporate failures, through increased and deserved confidence in business.

**1.6** There has been considerable discussion about the structure of the firms that deliver audit. This relates to questions of independence, access to specialist skills, career paths for auditors and the profitability of audit. At the same time there are anxieties expressed about the competitiveness of a market where only four firms audit FTSE-100 companies, and the vast majority of those in the FTSE-250 index. In establishing the terms of reference for this Review, I was asked to make recommendations to improve the quality and effectiveness of the product itself.

**1.7** Whilst increased competition would be likely to improve quality, this topic has been widely covered by the CMA and therefore I have designed my recommendations to be appropriate regardless of the emerging competitive landscape. As to independence, it will be for the firms conducting audit to be able to demonstrate that appropriate independence has been exercised and for regulators to judge the evidence. I have made recommendations around transparency that will help, whatever definition of independence is employed.

**1.8** Perhaps the most controversial recommendation is that from the CMA<sup>4</sup> regarding joint audits. I did not seek evidence in relation to this concept amongst either users or producers of audit. Nonetheless I have received many negative comments from both. It is not clear to me that joint audits would improve the quality of audit in anything but the long term and, even then, with no certainty. However, I recognise that there may be competition imperatives which are viewed as more important and accordingly I have deliberately chosen not to opine on the merits or otherwise of such proposals.

**1.9** Competition issues aside, throughout this Report I have endeavoured to make recommendations that will improve quality and effectiveness in all other respects.

**1.10** I hope that this Report can, together with other action being taken by government and regulators, help auditors earn back shareholder and wider public confidence.

**1.11** In order that my recommendations can be taken forward with appropriate urgency, it is important that the Audit, Reporting and Governance Authority (“ARGA”), the successor body to the Financial Reporting Council, be established with the necessary powers as soon as possible. Importantly, I do not see ARGA as creating a new regulatory burden but, rather, as envisaged by Sir John Kingman<sup>5</sup>, making effective the role of the regulator.

**1.12** Finally, all the views expressed in this Report are mine alone and I am responsible for any errors or omissions.

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<sup>3</sup> Monika Causholli and W. Robert Knechel, *An Examination of the credence attributes of an Audit*; Accounting Horizons: Vol 26 (December 2012)

<sup>4</sup> Competitions and Markets Authority, *Statutory Audit Services Market Study – Final Report (April 2019)*

<sup>5</sup> Sir John Kingman, *Independent Review of the Financial Reporting Council – Final Report (December 2018)*

## 2. Summary of Conclusions

**2.0.1** This Report contains a substantial number of recommendations which should be taken together to stimulate **improved quality and effectiveness of audit** in the UK. They relate not only to the work undertaken by the auditor but to the part played by others in relation to the audit.

**2.0.2** At the heart of the Report lies the objective of making audit **more informative** to its users and therefore, by improving the cost and allocation of capital, adding value to the economy as a whole.

**2.0.3** The recommendations are collectively aimed at improving audit and assurance in relation to **Public Interest Entities (PIEs)**, which have been the focus of the Review in accordance with its terms of reference<sup>6</sup>. I recognise that the Government is in the process of addressing Sir John Kingman's recommendation that the existing definition of PIEs<sup>7</sup> be revisited. While the outcome of that work is awaited, I see no reason, in principle, why the recommendations in this report should not apply to any expanded group of PIEs, except for recommendations that are aimed specifically at listed companies.

**2.0.4** I am mindful that the terms of reference for this Review stated that any extension of assurance should be achieved proportionately where possible. I therefore recommend that the Government, in determining the implementation of each recommendation should consider the case for certain recommendations applying initially to the audit of PIEs in the FTSE 350 index, or in some instances, a subset thereof, and the extent to which they may be applied to PIEs outside the FTSE 350 index. The recommendations include the establishment of overarching Principles of Corporate Auditing which should have widespread application.

**2.0.5** I have endeavoured throughout to be mindful of the need for proportionality and, to help achieve this, the Report includes proposals to allow for more detailed audits where boards or shareholders consider it necessary.

**2.0.6** The recommendations encompass:

- A redefinition of audit and its purpose;
- The creation of a corporate auditing profession governed by principles;
- The introduction of suspicion into the qualities of auditing;

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<sup>6</sup> Appendix 2

<sup>7</sup> PIEs for existing UK regulatory purposes currently includes UK companies with equities or debt admitted to trading on a regulated market (including the London Main Market but not the Alternative Investment Market) and credit and insurance firms.



- The extension of the concept of auditing to areas beyond financial statements;
- Mechanisms to encourage greater engagement of shareholders with audit and auditors;
- A change to the language of the opinion given by auditors;
- The introduction of a corporate Audit and Assurance Policy, a Resilience Statement and a Public Interest Statement;
- Suggestions to inform the work of BEIS on internal controls and improve clarity on capital maintenance;
- Greater clarity around the role of the audit committee;
- A package of measures around fraud detection and prevention;
- Improved auditor communication and transparency;
- Obligations to acknowledge external signals of concern;
- Extension of audit to new areas including Alternative Performance Measures; and
- The increased use of technology.

**2.0.7** I have grouped and summarised these recommendations into broad themes below and give a brief description of the principal recommendations in each. I have drawn out the most important recommendations throughout the report in shaded boxes but have also included in the text (in bold) other proposals and suggestions. Together, these recommendations, proposals and suggestions provide my prescription for improving the quality and effectiveness of audit.

## 2.1 Audit Purpose

**2.1.1** Audit lacks a clearly understood and fully encompassing purpose. I propose that a fresh definition of purpose should be adopted and, ideally, enshrined in company law. Auditors should be guided to fulfil this purpose in carrying out their work. I recommend the following definition:

**“The purpose of an audit is to help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements.”**

**2.1.2** Such a purpose should reflect and reinforce audit (both the present statutory audit and the audit of any other corporate information) as a public interest function that demonstrates more than just compliance with laws and rules. Audit exists fundamentally to help its users know how confident they can be in the audited information and – by extension – in those who have produced that information.

**2.1.3** In addition, I recommend:

**Clarity and reinforcement of the need for auditors to provide decision useful information to the users of audit reports. Significantly that information should, on occasion, include original information (that is, to say, information not produced by the audited company for disclosure) that is likely to have a material impact on users’ decisions.**

## 2.2 A New Audit Profession

**2.2.1** Auditing is too important to be left to an adjunct of another profession: it should be an independent profession in its own right, with its own governing principles, qualifications and standards. At present it is an extension of the accounting profession, whose ethics and (arguably) mindset it largely adopts.

**2.2.2** I recommend that:

**ARGA should facilitate the establishment of a corporate auditing profession based on a core set of principles. ARGA should be the statutory regulator of that profession. In doing so, I recommend that ARGA develops a coherent framework for corporate audit that includes but is not limited to the statutory audit of financial statements.**

**2.2.3** This profession should encompass all ‘corporate auditors’, including the statutory auditors of the financial statements, and auditors of other corporate information, for example, information covering cyber security or related to environmental measures. Some of these corporate auditors may come from traditional audit firms, but others may come from new specialist audit entities. They must all serve the same audit purpose.

**2.2.4** I have proposed a set of principles within the main body of the Report – The Principles of Corporate Auditing. These seek to integrate and give more prominence to auditor behaviours set out in existing standards and codes, while adding additional principles around openness, independence, challenge and the public interest. Implemented and applied effectively, these principles should provide an incentive to deliver more informative audits and I would hope that the courts will consider adherence to them as part of any defence against future legal action which may claim that an auditor’s opinion has harmed the audited company. ARGA should also assess how auditors have followed the audit principles as part of their annual Audit Quality Reviews.

**2.2.5** I recommend that:

**ARGA should revisit the existing definition of professional judgment with a view to strengthening, and demonstrating better, the use of judgment in audit.**

**2.2.6** The Report offers suggestions as to how this might be done. The Report also introduces, in addition to the concept of professional scepticism, the need for professional suspicion.

## 2.3 The Audit Report

**2.3.1** The Report highlights the growing challenge in using ‘true and fair’ as a descriptor of financial reporting given that corporate accounting increasingly involves the use of estimates and judgments. Together with the fact that the audit intends to provide assurance that the company accounts are free of material misstatements, it is difficult to see how either directors or the auditor can communicate effectively that modern company accounts are ‘true’ in accordance with any reasonable person’s understanding of the word. This is just one contribution to the so-called expectations gap.

**2.3.2** I therefore recommend that:

**‘true and fair’ be replaced in UK company law with the term ‘present fairly, in all material respects’.**

**2.3.3** Lest anyone considers this may weaken the force of the opinion, I consider, to the contrary, that its accuracy will strengthen the value of that opinion.

**2.3.4** Directors should have a legal obligation to state that the financial accounts they present each year have been fairly presented in all material respects, and the auditor should have a corresponding duty to assess whether this is the case (in addition to fulfilling their continuing duties to assess whether the accounts have been “properly prepared” in accordance with standards and whether they have been prepared in accordance with the law).

**2.3.5** This will increase clarity in financial reporting and auditing, and strengthen the obligation on directors to deliver high quality accounts free from material errors and misstatement. The Report therefore also reiterates the opportunity for directors to depart from any accounting standard where justified by the need to ensure a ‘fair presentation’, while noting that auditors’ view of fair presentation should be informed by the proposed new principles for the audit profession, which include acting in the public interest.

**2.3.6** To enhance the informative nature of the audit report, I make recommendations about the need for auditors to:

**Create continuity between successive audit reports.**

**Provide greater transparency over differing estimations, perhaps disclosing graduated findings.**

**Call out inconsistencies in information made public.**

**Reference external negative signals and how they have informed the audit.**

**2.3.7** I also recommend retention of the binary audit opinion.

## 2.4 Directors’ reporting

**2.4.1** To help frame the role of the auditor(s) and to make clearer the extent of all assurance in regard to the information they communicate, I recommend that:

**The directors present to the shareholders a three-year rolling Audit and Assurance Policy.**

**2.4.2** This should indicate their approach to the appointment of auditors, the scope and materiality of all auditing (including that of the financial statements), the assurance budget and the relationship of any audit to identified risks. Shareholders would be invited to express their views on this policy in an advisory vote.

**2.4.3** I recommend that:

**The directors publish their statement of principal risks and uncertainties before determining the scope of each year's audit and actively seek shareholder and other views on the appropriate emphases.**

**2.4.4** To improve understanding of the resilience of their company, I recommend that:

**The directors publish a Resilience Statement which would incorporate a going concern opinion for the short term, a statement of resilience in the medium term and a consideration of the risks to resilience in the long term.**

**2.4.5** This Resilience Statement would replace the existing Going Concern and Viability Statements:

- The short term reporting component of the Statement would incorporate the existing going concern assessment, but with enhanced transparency, including the disclosure of material uncertainties that could impact on the company as a going concern before any mitigating action has been taken into account.
- The medium term component would be a more robust and transparent version of the existing Viability Statement. This component of the Resilience Statement should include stress testing of various scenarios that could threaten the company's business model, drawing on existing models currently used by the Prudential Regulation Authority for financial services companies.
- The long term component would provide an opportunity for directors to set out how they are positioning the business strategically to address the risks of, for example, climate change and other potential existential threats.

**2.4.6** The Report discusses how auditors would be expected to express views on each component with varying levels of confidence and places on the auditor an obligation to disclose any information they find within the company, or from external sources, during the course of the audit that materially contradicts anything in the Resilience Statement. It will be for shareholders primarily to judge the extent to which a company's Audit and Assurance Policy enables satisfactory assurance over the Resilience Statement as a whole.

**2.4.7** Furthermore, to recognise the legitimate interests of all users, I recommend that:

**The directors present an annual Public Interest Statement, which explains the company's view of its obligations to the public interest, whether arising from statutory, self-determined or other obligations, and how the company has acted to meet this public interest over the previous year.**

**2.4.8** This statement would provide an opportunity for directors to articulate in a holistic way how the company they govern serves the wider public interest. This is not an invitation to provide an exhaustive summary of every legal duty that the company or its directors comply with, but rather a concise explanation by the directors of how they perceive the public interest in their company, and how they have taken measures to serve that interest over the previous year.

**2.4.9** Again, the Report discusses the role auditors would be obliged to play in providing assurance in relation to this statement, and recommends that an opinion be provided as to whether the statement has been presented fairly.

**2.4.10** In relation to funding the assurance work, I recommend that:

**Audit committees agree an annual assurance budget, within which they have primary responsibility for negotiating and agreeing the audit fees, and which sets a framework for company spending on any other assurance work.**

**There should be enhanced transparency as to the audit fees.**

## 2.5 Role of shareholders

**2.5.1** I make a number of recommendations aimed at enabling and encouraging a company's shareholders to influence the scope of the audit, and to hold the Audit Committee and auditor to account. These are intended to complement the directors' new disclosure requirements.

**2.5.2** I recommend that:

**A process be established in which the company's shareholders are given a formal opportunity to propose any matters they wish to be covered in the audit.**

**2.5.3** Audit Committees would retain their decision-making rights but would be obliged to explain their reasons if they rejected such requests. This process should be informed by the earlier publication of the company's statement of principal risks and uncertainties so that shareholders' suggestions for the audit plan are based on an up-to-date understanding of the key risks facing the business.

**2.5.4** I also recommend that:

**There be a standing item on audit at the company's general meeting, to permit questioning of the Audit Committee Chair and the auditor.**

**2.5.5** Additionally, to help further promote a user-driven audit, I recommend that:

**The existing, largely producer-led, Audit Quality Forum be replaced with a new body, the Audit Users Review Board, to be co-ordinated by the Investment Association and bringing together a range of users of audit, including the Audit Committee Chairs Independent Forum, The 100 Group, institutional and retail shareholder representatives, and other users.**

## 2.6 Other stakeholders

**2.6.1** The statutory audit report is legally required to be prepared for the company's shareholders. However, by providing independent professional insight into the company's financial position, it is clearly of great relevance also to other stakeholders who depend on the company's ongoing viability. I believe that more can be done to reflect these wider interests.

**2.6.2** I therefore recommend that:

**The Principles of Corporate Auditing include a statement that auditors act in the public interest and have regard to the interests of the users of their report beyond solely those of shareholders.**

**2.6.3** I consider that this will enable wider interests to be considered without a general extension to auditor liability.

**2.6.4** Directors are now required to report annually how they have met their obligations under section 172 of the Companies Act and I recommend that:

**The audit report should include a new section in which the auditor states whether the director's section 172 statement is based on observed reality, on the basis of the auditor's knowledge of the company and its processes.**

**2.6.5** Employees are often well placed to provide insights or highlight concerns that should usefully be considered as part of the audit planning process, or during the audit itself. I therefore recommend:

**That directors actively seek the views of employees regarding the scope of any audit activity and report back to them how their views have been taken into account.**

**2.6.6** With regard to whistleblowing, I recommend that:

**The Statutory Auditor be added to the list of 'prescribed persons' under the Public Interest Disclosure Act.**

**2.6.7** This would allow employees legitimately to raise concerns and related information directly to the auditor provided that they meet the public interest criteria set out in the Act. I also recommend that Government look at widening the Act in this respect to enable customers and suppliers to raise concerns with the statutory auditor.

**2.6.8** The Report notes the relative lack of information in respect of performance regarding payments to suppliers within annual reports. I recommend that:

**Existing voluntary and statutory company disclosures on supplier payment performance be brought into the annual report, and be subject to a level of audit as described in the company's Audit and Assurance Policy.**

## 2.7 Fraud

**2.7.1** The Report includes a package of recommendations aimed at raising the prominence and transparency of fraud prevention and detection by both directors and auditors. These include:

**A new reporting duty on directors to set out the actions they have taken each year to prevent and detect material fraud.**

**A corresponding new duty on the auditor to state in their report how they have assured the directors' statement on material fraud, and what additional steps they have taken to assess the effectiveness of the relevant controls and to detect any such fraud.**

**2.7.2** This challenges the perception that auditors have no obligation to detect fraud. I consider that they should endeavour to.

**2.7.3** I further recommend that:

**Auditors be required to undergo initial and ongoing periodic training in forensic accounting and fraud awareness.**

**ARGA maintain an open access case study register detailing corporate frauds.**

**2.7.4** In order to mitigate the effects of any unfair use of hindsight in judging performance with respect to fraud detection, and recognising that it may simply be impossible to detect some frauds in a cost-effective way, I recommend:

**The establishment of an independent Auditor Fraud Panel to judge auditors' culpability in a manner similar to that followed by the Panel on Takeovers and Mergers.**

## 2.8 Kingman recommendations and other BEIS work

**2.8.1** I fully support Sir John Kingman's recommendations regarding the establishment of ARGA and the need for this to happen quickly. In this Report I have also made suggestions in other areas where Sir John has asked BEIS to take matters forward including in particular his recommendation that consideration be given to a strengthened framework for internal controls reporting, learning relevant lessons from the Sarbanes Oxley regime in the United States.

**2.8.2** While this has not therefore been central to my Review, the effectiveness of internal controls is clearly of great relevance to the reliability of a company's financial (and potentially other) reporting. I suggest therefore how directors might report more meaningfully on their internal controls and the potential role of the auditor in relation to that reporting.

**2.8.3** I recommend primarily that:

**The CEO and CFO provide an annual attestation to the board of directors as to the effectiveness of the company's internal controls over financial reporting and that this attestation be guided by new principles on internal controls reporting to be developed by the Audit Committee Chairs Independent Forum and endorsed by ARGA.**

**2.8.4** I recommend further that:

**Companies be required to disclose when any material failure of their internal controls has taken place. A disclosed failure would lead to the CEO/CFO attestation being subject to audit for the following three reporting years.**

**2.8.5** With regard to the Capital Maintenance Regime, I make recommendations to BEIS that:

**The directors, in proposing a dividend, need to make a statement that the payment in no way threatens the existence of the company in the ensuing, say, two years and that this dividend is within known distributable reserves.**

This known amount may not be the complete amount.

**2.8.6** By contrast,

**For a company where it is likely that distributable reserves are deemed “similar” in size to a proposed dividend, that dividend can only be recommended by the directors if the level of the distributable reserves is established and payment of that dividend is consistent with obligations of the directors under the Companies Act and consistent with the Resilience Statement. These distributable reserves would be subject to audit.**

## 2.9 Auditor Transparency

**2.9.1** To help to establish confidence in the corporate auditing profession, I make a number of recommendations for increased transparency. I recommend that:

**Audit firms ensure a clear separation between the team which negotiates the audit fees, and the team which carries out the audit(s).**

**Audit firms be required to publish the profitability of their work from audit, and also the remuneration of their Senior Statutory Auditors and the attendant performance measures around that remuneration.**

**Auditors disclose, within the audit report, the hours spent on each audit by each grade within the audit team.**

**Clear reasons be given for any resignation, dismissal or decision not to participate in a retender; auditors and companies should answer relevant questions in a general meeting.**



## 2.10 Other recommendations

**2.10.1** The Report includes a number of other recommendations on the following areas of relevance to audit quality:

### Technology:

**BEIS and ARGA work with auditors to create the necessary protections and policies for audit to be able to use data from the companies they audit in order to promote better quality audits.**

**Auditors explain in the audit report any use of sampling techniques.**

### Auditor Liability:

**Company law be amended to provide that any use of Liability Limitation Agreements by company boards, proposed in good faith, does not represent a breach of directors' responsibilities.**

### APMs and KPIs:

**Any Alternative Performance Measures reported by a company, and any use of Key Performance Indicators to underpin executive remuneration, should be subject to audit.**

### ARGA:

**A proposal to review and update its definition of a 'High Quality Audit' (taking into account a proposed definition in the report).**

**An obligation to produce and maintain a concise and informative Plain English guide to audit. A link to this guide, on the ARGA website, should be included in every audit report.**

**Encouragement to publicise good audits as well as chastising poor audits.**

**A requirement to develop guidance around the responsibilities of an auditor with respect to accounting records.**

**Establishment of a formal mechanism for shareholders and stakeholders to communicate concerns.**

## 2.11 Implementation

**2.11.1** Finally, I recommend that:

**A follow-up Review be conducted in 2025 to consider how the recommendations in this Report and those of the CMA and Sir John Kingman have been implemented.**

## 3. Introduction

“I know of no better system than market capitalism to sustain liberty and create prosperity – and market capitalism cannot function without a robust audit function. If we do not save auditing, we cannot save capitalism.”<sup>8</sup>

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**3.1** The origins of the present Review, a successor to various industry proposals, might be best summed up by the following comment in The Guardian in April 2019, in reference to the failures of Carillion and Patisserie Valerie: “[The auditors’] failure to spot the fragility of those businesses resulted in the loss of jobs, savings, pensions, and tax revenues.”<sup>9</sup>

**3.2** I am very conscious that there have been two other Reviews recently – the Independent Review of the Financial Reporting Council (“FRC”) by Sir John Kingman and the Statutory Audit Services Market Study by the Competition and Markets Authority (“CMA”) – which are relevant to the future of audit. In addition, there have been many recent contributions including The Future of Audit Report from the BEIS Select Committee<sup>10</sup>. Over the past few years there have been numerous other reports, examinations and studies. In conducting this Review, I have endeavoured to consider this body of work as a whole in coming to my recommendations.

**3.3** All this work contributes to the overall commentary on corporate governance. Sometimes it feels to me that this commentary takes place in a vacuum, neither recognising current and immediate market pressures nor the need to prioritise resources in companies to deal with a myriad of problems both immediate and long term. ***It would be helpful if ARGA would play the role of a clearing house to ensure that boards are not over-encumbered with competing corporate governance priorities.*** In this connection I also welcome Sir John Kingman’s comment<sup>11</sup> that ARGA “should be more sparing and disciplined than the FRC in promulgating guidance and discussion documents.”

**3.4** Much of the academic work on audit I have reviewed focuses on a holistic approach which recognises the complexity of the environment within which audit sits. ***Here also ARGA could play a positive role in facilitating a stronger interaction between academia, the professional bodies, firms, investors, other users and itself.***

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<sup>8</sup> Karthik Ramanna, *Building a culture of challenge in audit firms* (September 2019)

<sup>9</sup> Prem Sikka, *The Big 4 auditors are failing – and the watchdog’s report won’t change that*; The Guardian (18 April 2019)

<sup>10</sup> BEIS Select Committee, *The Future of Audit* (April 2019)

<sup>11</sup> Recommendation 31, *Independent Review of the Financial Reporting Council* (December 2018)

## MacFarlane Report

**3.5** It was startling to discover the extent of the relevance of the MacFarlane Report of 1992,<sup>12</sup> commissioned at that time by the relatively new Auditing Practices Board (“APB”). A small sampling of that report identified the following anxieties about audit:

- there is a gap between the role expected of auditors and that performed by them today;
- there is a demand for auditors to recognise the interests of a wider group than shareholders alone;
- there are perceived gaps in the scope of audit, particularly regarding directors’ stewardship, future prospects and risks, fraud, internal controls and interim reporting;
- the development of a more effective and responsive audit is constrained by the prospect and scale of potential litigation; and
- there should be a cultural shift in the audit so that it looks forward as well as backward.

**3.6** I have heard all of these comments repeated in 2019 accompanied by a very considerable irritation that there has been no significant progress since 1992 in addressing them.

## Interaction with Kingman and CMA Reviews

**3.7** There are a small number of matters arising from Sir John Kingman’s Review that overlap issues of audit quality and effectiveness that I have considered in this Review. This includes the issues of internal controls, duty of alert and the viability statement. The recommendations I make on these matters can be considered inputs to the BEIS work to take forward the Kingman recommendations.

**3.8** In undertaking my work, which has followed on from the work of the CMA and Sir John Kingman, I took the view that it would be counterproductive to reopen issues where those Reviews have made clear recommendations. Inevitably I have found that recently the headline-grabbing discussion of the future and structure of the so-called “Big 4” firms<sup>13</sup> has dominated the discourse about audit. For example, the recommendations of the CMA around the desirability of joint audits have been front of mind for most audit committee chairs and directors. Some would have liked my Review to have expressed opinions on the impact of possible joint audits on the quality of the audit<sup>14</sup> and the consequences in terms of clarity about liability incurred. Whilst I have no doubt that there will be a relationship between joint audits and quality, it is far from clear what the impact of such audits would be on quality. As this possibility remains for the future and there is no UK data on which to base judgments, I saw no purpose being served by further entering the discussion on this topic. BEIS has consulted<sup>15</sup> on the CMA proposals and the results of that work are awaited.

<sup>12</sup> Auditing Practices Board, *The Future Development of Auditing* (November 1992)

<sup>13</sup> Deloitte, EY, KPMG and PwC

<sup>14</sup> This point was made early and forcibly to me by Mazars LLP at the time the terms of reference of my Review were being established.

<sup>15</sup> <https://www.gov.uk/government/consultations/statutory-audit-services-initial-consultation-on-the-competition-and-markets-authority-recommendations>

## Call for Views

**3.9** Instead, in my Call for Views published on 10th April 2019,<sup>16</sup> I endeavoured to set a framework and ask questions which would point to possible ways of improving quality and effectiveness and which would be equally applicable in a world with joint audit as without.

**3.10** I am delighted that I received 120 formal submissions comprised of around 2,500 pages of comment and found an open-mindedness and willingness to engage from all quarters inside and outside the UK. These responses are published online alongside this Review<sup>17</sup> and I hope will form a useful repository of information for research purposes. A high level summary of the responses is provided at Appendix 1 to the report. I also received considerable advice in over one hundred meetings and roundtables with a wide variety of interested parties<sup>18</sup> and I would like to thank all those who shared thoughts and gave of their time to participate.

**3.11** In thinking through the recommendations of this Review I have been particularly struck by a remark made to me earlier this year: “The current environment is an extremely challenging one for companies, with an increasing regulatory burden, growing obligations to an ever wider group of stakeholders, an ongoing public debate about the purpose of companies and the role they should play in society as a whole, and all of this in a climate which is becoming suspicious of private enterprise and individual commercial success.”<sup>19</sup> I have viewed it as important to endeavour not to make this environment even more demanding on boards and companies in a manner which fails to add value, but nonetheless to respond to calls for audit to be refocused to serve a wide public interest.

**3.12** At the same time, I have been mindful not to damage the UK’s competitiveness either through adding unnecessary cost burdens or by proposing obligations likely to deter capital raising in the UK. I believe I have achieved this.

**3.13** I am also optimistic that the concepts laid out in the recommendations are capable of being applied universally, addressing as they do problems that have occurred in jurisdictions as far apart as the United States and India, and Canada and Australia.

## The audit environment

**3.14** In order to make recommendations to improve the quality and effectiveness of audit it has been necessary to consider the context in which audit takes place and the interactions between the auditor, the audit process and a range of other actors. To make the audit itself of better quality and more effective, changes need to be made by those other actors also. Audit interacts with many participants – management, non-executive directors, standards setters, regulators, users of accounts (shareholders and others) – who all need to play their part to create a fully functioning environment. One weak link can undermine all the others. That is why it has been necessary in this Review to stray from considering the activity of the auditor alone and to consider adjustments to the environment that will improve trust in its entirety.

**3.15** During the Review, I heard, in many discussions, a dissatisfaction with current accounting standards and the consequent preparation of accounts. Some confused dissatisfaction with accounting with what they perceived as shortcomings in auditing. Some would say that, in a world of increasing real-time information, accounts become a validation record of arcane detail to which increasingly little attention is paid. One correspondent described the auditors’ income

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<sup>16</sup> <https://www.gov.uk/government/consultations/the-quality-and-effectiveness-of-audit-call-for-views>

<sup>17</sup> Where permission has been granted.

<sup>18</sup> I am particularly grateful for the assistance of the ICAEW and ICAS in facilitating some of the roundtables.

<sup>19</sup> Trelawny Williams, Senior Advisor, Corporate Governance, Brunswick Group (June 2019)

as coming from “adding assurances to historical financial reports that are decreasing in value to users, thus the audit/attest service has decreasing utility. The value of an audit can be no greater than the value of the subject matter on which the auditor opines.”<sup>20</sup>

**3.16** So that no expectations are raised, this Review takes existing accounting standards as they are, not as some would like them to be. Recommending changes to accounting standards is beyond my terms of reference.

**3.17** Nevertheless, I have allowed this Review to include recommendations about the behaviour of directors, audit committees, shareholders and regulators and about actions that can be taken by all four to create an environment which will permit better and more effective audit.

**3.18** I have not endeavoured to draft precise changes to the law but rather tried to frame recommendations to indicate their spirit to allow others with appropriate skills to do so.

## Time for action

**3.19** The 2018/9 triangle of Reviews by the CMA, Sir John Kingman and this Review should, to be effective, be capable of being taken as a whole and I hope will form the basis of significant reform. Other work<sup>21</sup> too, such as that by the FRC in relation to the Going Concern auditing standard, has helped to inform further the debate. It is my hope now that the time for major Reviews is over for several years and that legislative and regulatory action will follow. Nonetheless, to check on the progress made,

**3.20 I recommend that there should be an Independent Implementation Review in 2025 to report publicly on the progress made in relation to the recommendations made by each of these three Reviews.**

**3.21** I would like to thank all those others who engaged with this Review for the time and attention they paid to all the questions raised. In particular, I would like to thank the ICAEW and the FRC for their active support with the Review. I was also helped by two advisory groups where it was possible to have useful and private discussion to help form and test ideas. The minutes of these groups’ meetings are similarly published online today alongside this Report.<sup>22</sup> I thank the members of these groups for their time, patience and wise counsel.

**3.22** Finally, I had the support of a remarkable team consisting of Tom Barrett, Miranda Craig, Paul Lee, Robin Mueller and Robyn McNally for whom no task was too much trouble. At various times I also had the assistance of Steve Leonard, Dr Yasmine Chahed, Rochelle Duffy and many others whose advice was invaluable. This report could not have been prepared without their energy, skill, patience and understanding. I thank them all.

<sup>20</sup> Former Arthur Anderson partner in private letter (May 2019)

<sup>21</sup> See Appendix 4 for other related work on audit in 2019

<sup>22</sup> <https://www.gov.uk/government/publications/the-quality-and-effectiveness-of-audit-independent-review>

## 4. Expectation and Other Gaps

**4.1** It would not be possible to write this Report without an explicit reference to what many call the “expectation gap”. Indeed, I have encountered a series of “gaps” regarding audit. These, of course, start with the expectations gap but add a performance gap, a knowledge gap, an evolution gap, a hindsight gap<sup>23</sup>, a quality gap, a misperception gap,<sup>24</sup> and a methodology gap.<sup>25</sup> At one of the Auditors’ Advisory Group meetings an education gap was also raised. The BEIS Select Committee particularly focused on what it saw as a delivery gap.<sup>26</sup> Others<sup>27</sup> express the view strongly that the expectations gap is an invention of the accounting profession used to blame users for failing to understand what the profession does.

**4.2** Given that there are many definitions of audit it is hardly surprising that a polyphony<sup>28</sup> of expectations has developed around them.



<sup>23</sup> Submission by BDO (7 June 2019)

<sup>24</sup> Submission by CFA Institute (16 August 2019)

<sup>25</sup> Rosmini Upsi, Vicky Forgie and Khalizul Khalid, *Bridging the environmental accounting gap between the accounting and economics disciplines*; American Journal of Finance and Accounting, vol. 2, issue 4, 297-310 (2012)

<sup>26</sup> BEIS Select Committee, *ibid*

<sup>27</sup> “Auditors like to highlight an ‘expectations gap’, which refers to the fact that the public misunderstands the auditor’s role, and worse still overestimates what auditors can do. In our view, this characterisation is not just self-serving, but flawed. The problem is not one of expectations, rather we have a grave ‘delivery gap’ when it comes to audit.” Sarasin & Partners submission (June 2019)

<sup>28</sup> Fig. 1 credit Dr. Yasmine Chahed

**4.3** MacIntosh<sup>29</sup> usefully describes the central expectation gap as “the difference between the public’s beliefs about the nature of accounting reports and the claim that accountants and professional bodies are wont to make to the effect that all that is guaranteed is that the reports are prepared in accordance with the currently prevailing generally accepted accounting principles and standards.”<sup>30</sup>

**4.4** I find all this focus on the expectations gap is a distraction. Either audit is helping to reinforce deserved confidence in business or it is not. What is required is better<sup>31</sup> audit delivered by professionals in a more understandable framework.

**4.5** It has been argued that it would be helpful for all users of the audit report if an enhanced set of definitions and explanations could be reproduced in annual reports<sup>32</sup> “about the remit of the audit” and “to help clarify the responsibilities and accountability of the auditors”. However, annual reports and accounts are already very long.

**4.6** Rather, in addition to the substantive recommendations for audit quality improvement that I make in this Report,

**4.7 I recommend that ARGA together with auditors and the Plain English Campaign produce an appropriately concise guide to audit, explaining clearly what the different elements of an audit report mean as redefined in this Report and what, just as importantly, they do not mean.**

**4.8** ARGA should provide access to this document to enable it to be signposted in every set of annual report and accounts in a standalone manner.

**4.9** Some are frustrated with the analysis of gaps: there is a clear body of opinion that believes that, as far as today’s statutory audit is concerned, all that is required is that there is literal following of the law and what might be described as “doing it properly”.<sup>33</sup> In my view, the improvement of audit should go further.

**4.10** This Report deals with all the various gaps by endeavouring to make audit a more informative process and product.

<sup>29</sup> Norman MacIntosh, *Accounting, accountants and accountability, post structuralist positions*; Routledge, London & New York (2002)

<sup>30</sup> For an amusing but relevant poem see Appendix 8

<sup>31</sup> One transatlantic call illustrated the quagmire that is audit well when I was asked what I meant by “better”!

<sup>32</sup> Submission by The Sage Group plc (7 July 2019)

<sup>33</sup> Submission by Local Authority Pension Fund Forum (22 May 2019)

## 5. A redefinition of audit and its purpose

### 5.1 Purpose

**5.1.1** There is no shortage of debate and discussion of the future of audit but I found, in the words of Professor Chris Humphrey<sup>34</sup>, a member of the Review’s Advisory Board, that the debate so far “encourages a form of analysis where incremental change is probably the most likely recommendation and outcome, where old ‘hobby horses’ (such as the expectations gaps or the value of IFRS<sup>35</sup> and the case for prudence) frequently get resurrected, where people seek to dominate a collective discussion with their singular perspectives, and quite quickly we end up in a discussion that we seemed to have had many times over; a debate which is notable only for its familiarity and circularity – and, if any radicalism does emerge, it tends to come in the form of speculative proposals that antagonise rather than resolve, and which, ironically, reinforce or ground analysis in what we have come to accept and understand as audit (with a frequent refrain to proposed extensions in the audit being dismissed as ‘not audit’).”

**5.1.2** I consider that the concept of audit needs to be rethought and redefined. This redefinition needs to be rooted in a widely accepted clarification of its purpose. To achieve this,

**5.1.3 I recommend that the following statement be endorsed and adopted by ARGA and, insofar as it applies to statutory audit, the Government should consider how it may best be enshrined in the Companies Act (“CA06”)<sup>36</sup>:**

**5.1.4 “The purpose of an audit is to help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements.”**

**5.1.5** In seeking to enshrine an audit purpose in law as something to which auditors should have regard while carrying out their duties, there may be precedents in the way s172 CA06 operates (requiring directors to have regard to certain matters) and in the Public Sector Equalities Duty in the Equalities Act (requiring public authorities to have due regard to certain matters). I also

<sup>34</sup> Chris Humphrey, Professor of Accounting, Alliance Manchester Business School, *Organising thoughts on Audit*; note to Review team (May 2019)

<sup>35</sup> International Financial Reporting Standards

<sup>36</sup> I have confined this Review to businesses alone. It will be for others to determine if there are reads across to other areas of economic activity.



note that the recitals to EU Regulation 537/2014 (covering the audit of Public Interest Entities) attempt to describe the purpose of statutory audit<sup>37</sup>. At a minimum, the purpose should create an obligation to have regard to maintaining deserved confidence.

**5.1.6** The primary responsibility for maintaining confidence in a company remains, of course, with its directors.

**5.1.7** The discussion of the role of audit and its relationship with other users of its reports, other than the shareholders for whom the report has been contractually prepared, has been bedevilled by anxieties about auditors' legal liability. There needs to be a disconnection between risk of liability and acceptance that users other than shareholders may and will also make decisions based on the audit report. Here decisions to take action or not to take action are equally important. Society has demanded a publicly available report and, in consequence, non-shareholders will also make use of it. Auditors should have regard to this reality without any extension of legal liability beyond that owed to the shareholders as a body. I will argue later for the adoption of overarching principles to govern audit as a profession and therein would lie the guidance as to how auditors may recognise that their report will be legitimately used by others. Hence the inclusion of the reference to "other users" above.

## 5.2 Audit and decision usefulness

**5.2.1** In 2003 it was argued that "it is on grounds of its claimed expertise that the accounting profession has been granted an exclusive responsibility for independently pronouncing on the truth and fairness of financial reports. Responsibility to define "true and fair" runs parallel to this privilege."<sup>38</sup> In the UK it is a Companies Act obligation on the directors to prepare accounts that are true and fair.<sup>39</sup>

**5.2.2** A focus on decision usefulness underlies both IFRS and US GAAP, rather than on truth, and reflects financial reporting's ultimate objective. In doing so it goes to the heart of the debate about what is "true". "The adjectives used to describe recent accounting scandals indicate the pervasiveness of belief that some kind of veracity inheres in accounting reports... The centrality of truth to accounting is most evident in the exclusive franchise of the audit function. But the standard verbiage of an auditor's opinion says absolutely nothing to the effect that the auditor is providing assurance that the financial statements are providing assuredly decision useful information."<sup>40</sup>

**5.2.3** Decision usefulness is defined<sup>41</sup> as providing data useful for facilitating prediction, for example to help assess the timing, amount and uncertainty of future cash flows. Interestingly, in defining a "high quality audit" the FRC<sup>42</sup> states that, inter alia, such an audit provides a "trustworthy basis for taking decisions."

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<sup>37</sup> "Statutory auditors and audit firms are entrusted by law to conduct statutory audits of public-interest entities with a view to enhancing the degree of confidence of the public in the annual and consolidated financial statements of such entities." <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32014R0537>

<sup>38</sup> Brian West, *Professionalism and Accounting Rules*; Routledge (2003)

<sup>39</sup> s393(1) CA06 – Accounts to give true and fair view: (1) The directors of a company must not approve accounts for the purposes of this Chapter unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss.

<sup>40</sup> Mohamed E. Bayou et al, *To tell the truth: A discussion of issues concerning truth and ethics in accounting*; Accounting, Organizations and Society, Vol 36, Issue 2 (2011)

<sup>41</sup> IASB Conceptual Framework for Financial Reporting , OB3 (issued 2010, revised 2018)

<sup>42</sup> Financial Reporting Council, *Developments in Audit* (2017)

**5.2.4** I have some sympathy with the view expressed by Williams and Ravenscroft in 2010<sup>43</sup> that decision usefulness is “a vacuous notion since there is no way that any standard actually improves the prediction of cash flows.”<sup>44</sup> However, users want the basis of their decision making secured by trustworthy information and what is needed is confidence in the business about which decisions are being made. In that sense alone the audit itself must provide decision useful information.

**5.2.5** In meeting the newly defined purpose,

**5.2.6 I recommend that auditing should provide information that is useful to present and potential investors, lenders, creditors and other users in making rational investment, credit and other decisions and assessments about the company.**

**5.2.7** As with the proposed purpose of audit set out above, ***ARGA should adopt and monitor compliance with this obligation by auditors, and government should consider the extent to which it may be placed on a statutory footing in the Companies Act.***

**5.2.8** Although the law does not specify the relationship between an audit and the members of the company concerned beyond the fact that the auditors must prepare a report for the members<sup>45</sup>, there is a widespread perception that its purpose already extends or should extend to serving a wider public interest, as well as the interests of shareholders. This perception is supported by the requirement for an audit being a matter of law, with the auditor’s report having to be made public through an obligation to file the report with Companies House<sup>46</sup>, and reinforced by international and UK financial reporting standards. In this context, I note that IFRS, under which all UK-listed entities must report, identifies the primary users of financial statements as existing and potential investors, lenders and other creditors.<sup>47</sup>

## 5.3 New Information

**5.3.1** To satisfy this purpose of serving a wider public interest,

**5.3.2 I recommend that auditors should be free to include original information, materially useful to a wide range of users, in their audit report and at the AGM, and not be confined to commenting on that which has already been stated by directors.**

**5.3.3** I see this as a most important step in moving audit to be an informative function, in addition to one concerned with compliance. After all, it is difficult to place trust in someone, acting on one’s behalf, who one suspects of possessing lawfully obtained information that is useful but who is not willing or is unable to share it. This is especially true when one is paying for the service provided, as the shareholders are.

**5.3.4** The restriction that appears to prevent any new information being disclosed by the auditor stems from an interpretation of ISA (UK) 701 which states that “original information is any information about the entity that has not otherwise been made publicly available by the entity ... Such information is the responsibility of the entity’s management and those charged

<sup>43</sup> Paul Williams and Sue Ravenscroft, *Rethinking decision usefulness*; Contemporary Accounting Research, Vol. 32, No. 2 (2014), paraphrased by Bayou et al ibid

<sup>44</sup> Bayou et al ibid

<sup>45</sup> s495 CA06

<sup>46</sup> s447 CA06

<sup>47</sup> IASB ibid OB5

with governance”.<sup>48</sup> It goes on to say that “It is appropriate for the auditor to seek to avoid the description of a key audit matter inappropriately providing original information about the entity...When such information is determined to be necessary by the auditor, the auditor may encourage management or those charged with governance to disclose additional information, rather than the auditor providing original information in the auditor’s report.”<sup>49</sup>

**5.3.5** It is arguable whether this absolutely prevents an auditor from disclosing original information or merely discourages the practice.<sup>50</sup> Indeed ISA (UK) 701 allows auditors to take existing management derived information, and present, comment on, or interpret it in the audit report in a way which is ‘informative’ to the users, thereby in some sense creating new ‘information’. Importantly auditors are not prevented from opining on what they have observed.

**5.3.6** Audit’s purpose – “to help establish and maintain deserved confidence in a company” – should be achieved through a process of examination, testing and assessment that is rigorous, independent and honest. This is important because it is widely acknowledged that the cost of capital will be lower the greater the confidence in the entities seeking capital<sup>51</sup>, whether through public markets or by other routes. Trade and commerce also depend on consumers and suppliers having trust in the entities with whom they deal.

**5.3.7** Audit today, however, is fundamentally restricted to assuring the material accuracy of the financial statements and, even with this restricted scope, is only partially meeting even that objective<sup>52</sup>. Auditors also have an obligation to call out any materially misstated information they may see in the rest of the Annual Report or any information that is materially inconsistent with the financial statements. Not only must there be an improvement in the quality of the current activity, that activity needs to be part of a coherent framework of audit as a whole if trust is to be regained and maintained.

**5.3.8** In the course of their examination and assessment, auditors may become aware of other information, whether in the Annual Report, or published elsewhere by the company, which in their professional judgment would be significantly useful to those using their audit report and which the directors are not communicating, in the auditor’s opinion, with sufficient clarity. In exercising professional judgment as to when it would be appropriate to communicate this information, the usefulness of such information to users of the audit report should have to pass a materiality test. It would need to be likely to influence decision making by any users of the audit report in a significant way.

**5.3.9** To be clear, it would not be an obligation of the auditor to seek such information, the nature of which may in any event lie beyond the competence of the auditor to assess, but when discovered in the course of the audit work, and passing the materiality test, it would need to be disclosed. Ideally this would be by the directors following a request from the auditor, but, if the directors refused, by the auditor. ***ISA (UK) 700 should be amended to require the disclosure of any such information in the audit report.***

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<sup>48</sup> ISA (UK) 701 A35

<sup>49</sup> ISA (UK) 701 A36

<sup>50</sup> The argument here is consistent with the PCAOB’s observation for the USA “that auditors already have pre-existing duties to disclose original information in certain circumstances.” For example “when they have substantial doubt about the company’s ability to continue as a going concern” or “when in an audit of internal control over financial reporting, the auditor identifies a material weakness that has not been included in management’s assessment” (see pp. 43-44 <https://pcaobus.org/Rulemaking/Docket034/2017-001-auditors-report-final-rule.pdf>)

<sup>51</sup> For example, “When faced with increased uncertainty about the reliability of financial reports, investors may ‘price protect’ that risk by increasing the company’s cost of capital.” SEC (Dec 2018) (<https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other>)

<sup>52</sup> “25% of assessed audits are below an acceptable standard” Latest *FRC Audit Inspections* (10 July 2019)

**5.3.10** In practice I anticipate that any auditor discovering information of the nature described in this section would, in the first instance, discuss with management the appropriate way for the information to be disclosed and, if this did not result in agreement, would communicate this disagreement to the audit committee.

**5.3.11** Today the auditor has an obligation to read and consider other information in the Annual Report and to report if they consider it to be materially misstated.

**5.3.12 I recommend that this obligation should be extended to material outside the Annual Report that is used in investor presentations and RNS announcements.<sup>53</sup>**

**5.3.13** Such reporting would not lend itself well to standardisation (other than in, perhaps, a definition of the materiality test) but rather rely upon the professional judgment of individual auditors in seeking to fulfil the audit purpose outlined above. The extent to which they are seen to exercise this judgment effectively ought, in time, to become one of the differentiating features of the market for audit services. I fully recognise that this will require a change in the mindset of many auditors and I will say more about training and education later in this Report.

**5.3.14** The threat of this process should prove powerful in improving directors' disclosures.

**5.3.15** I have been warned throughout conducting this Review to be wary of unintended consequences of auditor disclosures. However, I am guided by Lord Bingham who made clear in his 1992 report that “the adverse consequences of making a disclosure, otherwise proper, surely cannot be a reason for not making it.”<sup>54</sup> Auditors' first disclosures are to the audit committee and public disclosure should not be compromised by fear of the outcome. There is, nonetheless, an important distinction to be made in relation to regulated and systemically important companies. ***In respect of such companies, the auditor's disclosure should be made to the relevant regulator whose advice should be sought as to wider publication. The regulator should have a presumption in favour of disclosure unless it is clearly not in the public interest to do so.***

## 5.4 Audit and assurance

**5.4.1** Today, in the UK, audit as a concept is largely defined through a collection of prescriptive standards under which the statutory audit of financial statements is carried out.<sup>55</sup> Nonetheless, as one respondent said, “transparent, informative and accurate financial reporting is a critical component of well-functioning public markets.”<sup>56</sup> This comment goes beyond the confines of adherence to standards and encapsulates a widespread hunger for information.

**5.4.2** I consider that this restrictive definition of audit no longer serves the purpose for which it was initially intended. The restriction to “financial statements” confuses users and does not fit with the general expectations of either the primary users or other stakeholders. Today's audit is a relatively arcane activity, operating within very precise rules, where the output of the auditor, even if precisely correct, cannot satisfactorily fulfil the desire of stakeholders to understand

<sup>53</sup> For information that would influence decision making by investors, that information would already be caught by the Market Abuse Regulations (“MAR”). Thus, information relevant to MAR is a subset of that which an auditor might disclose. In practical terms directors would be very unlikely to persist in non-disclosure in the face of a threat by the auditor to disclose.

<sup>54</sup> [Inquiry into the Supervision of the Bank of Credit and Commerce International](#) (October 1992)

<sup>55</sup> ISAs (UK) issued by the FRC

<sup>56</sup> Submission by London Stock Exchange Group (14 June 2019)

the resilience of the entity whose financial statements are subject to this audit. Confidence in the resilience of a company is a necessary component of deserved confidence. This Report emphasises the importance of resilience later.

**5.4.3** At the same time, I have found that there is widespread confusion between the terms assurance, audit and statutory audit. This confusion is driven, I believe, by this structure of statutory audit. This has caused audit as an overall concept to be synonymous, in the corporate world, with this narrower statutory audit, focused primarily on financial statements. This has happened even though the expectations of audit link to wider concerns.

**5.4.4** This point is referenced in one submission<sup>57</sup> which even calls out the Call for Views for falling into this trap. I do not believe the criticism to be justified as no distinction had been drawn between statutory audit and audit in any wider sense, but that the possibility of confusion arose illustrates the difficulty well.

**5.4.5** *To clarify, I consider the audit process and associated outcomes should be directed to achieve the purpose of audit, and therefore should provide those for whom it is carried out confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements.*

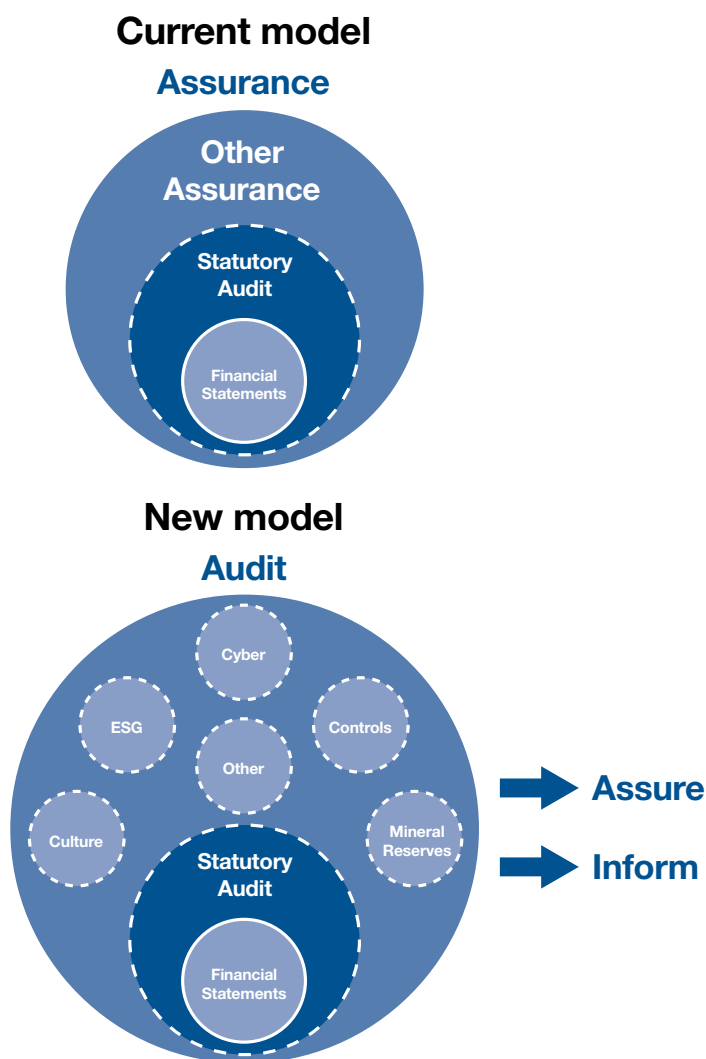
**5.4.6** This definition does not confine information to that relevant to the financial statements but can embrace other information relevant to users of an audit. There will remain, however, at the core, the information contained in the financial statements. At different times, and in relation to different companies, the choice of other information to be audited may vary.

**5.4.7** Audit defined in this way would not be therefore just part of an accounting landscape, nor necessarily the purview of accountants alone. Accountants may be professional auditors but the definition of an auditor needs to be redrawn, and accountants need not be the only professional auditors. To aid with understanding, today's statutory auditors need a new name, such as 'financial statement auditors.'

**5.4.8** The following figure illustrates the new audit model I propose and how this compares with the current model.

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<sup>57</sup> Submission by Crowe UK LLP: "Even in this 'Call for Views', there is reference to whether additional statements should be subject to 'audit', when the reference should be to external assurance." (7 July 2019)



**5.4.9** In this new model there would also be different levels of assurance given by different auditors, depending on the field of activity concerned and the brief given to the auditor by the audit committee. The same principles would guide them all, but the same standards would not necessarily apply to all.

**5.4.10** In this context I consider that the concept of reasonable assurance leads to misunderstanding amongst users. It intends to convey a high but not absolute level of confidence that there are no material misstatements. In contrast, “limited assurance” provides a lower level of confidence. However, assurance can be a function of many variables: time, circumstances, environment, data, access, and cost, for example. The level of assurance that an auditor can reasonably obtain in relation to different aspects of today’s financial statements will vary. The same is likely to be the case as regards different industry sectors. This reality does not seem to be clearly acknowledged by auditors and conveyed to users of their reports.

**5.4.11** Evidently there is a need for a rational framework with common understanding within which auditors can work and therefore:

**5.4.12** I recommend that ARGA determines a framework for all corporate auditing, whether of financial statements or of other information.<sup>58</sup>

<sup>58</sup> In doing so it will need to be mindful of the interaction with the International Auditing and Assurance Standards Board (“IAASB”) Assurance Framework.

**5.4.13** As I have said, language is important and, whilst “definitions of audit are dependent variables to be explained,”<sup>59</sup> Michael Power goes on to make a wider point, “Vagueness is an important part of the audit explosion phenomenon; it is a vagueness which is *observed* rather than created by the author... The idea of audit, consisting of some very general and highly idealized elements, is appealed to and used in a wide variety of policy contexts which tend to assume its capabilities and effectiveness... The rise of auditing is as much about the cultural and economic authority granted to people who call themselves auditors as it is about what *exactly* these people do. Indeed, we know that the people we call auditors (and inspectors) actually do many different things... Calling certain activities ‘audits’ places them within a different field of social and economic relations and expectations as compared with calling them ‘assessments’ or ‘evaluations’. Indeed, by labelling activities as audits, it becomes possible for them to acquire the idealized characteristics of audit over time.”<sup>60</sup>

**5.4.14** This Report starts with audit as the statutory audit of financial statements and then seeks to redefine audit as a whole in relation to the reporting of information by corporate entities. The use of the term audit for this activity should, in time, give the same idealised characteristics to audit as a whole as Power suggests.

## 5.5 Audit standards and the law

**5.5.1** The audit of companies’ financial statements in the UK has been shaped by developments in company law and more recently in the auditing standards set in the UK by the accountancy professional bodies, the APB established in 1991 and (since 2004) the FRC. The UK standards are adapted from those set by the IAASB. The interpretation of this statutory and standards-based regime has also been influenced by a number of landmark legal cases<sup>61</sup> over time.

**5.5.2** CA06 defines the duties of an auditor and requirements of an audit<sup>62</sup> but is not explicit as to its purpose and does not look beyond the companies’ members as its beneficiaries. The absence of clear statutory definition of the purpose of audit has left scope for the courts to play a significant role in determining auditors’ responsibilities, the manner in which they are discharged and to whom they owe a duty of care. I consider by adopting the definition of purpose proposed above this scope will be lessened, giving more clarity.

**5.5.3** The audit product has evolved over time in terms of presentation and supporting information. However, its core outputs have remained largely unchanged in the UK since 1947, when the phrase “true and fair” was introduced into auditors’ reports (from 1879 to 1947 the mandated expression was “true and correct”)<sup>63</sup> and, for the first time, auditors were required to report on the profit and loss account as well as the balance sheet. Unsurprisingly, some have concluded that the audit has not kept pace with the many changes affecting the business environment since then.

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<sup>59</sup> In relation to the policy space within which audit occurs. Power *ibid*

<sup>60</sup> Power *ibid*

<sup>61</sup> e.g. *Caparo Industries plc v Dickman* (1990) and *Royal Bank of Scotland v Bannerman Johnstone MacLay* (2002)

<sup>62</sup> In particular under s495 & s498 CA06

<sup>63</sup> The Australian auditing profession has used “true and fair” since 1974 whilst the EU requires “a true and fair view in accordance with the relevant financial reporting framework” (Article 28, Directive 2006/43/EC as amended by Directive 2014/56/EU). Other countries using variants of “true and fair” include France, Germany, Hong Kong and India.

## 6. A new profession: Corporate Auditing

“If the people be led by laws, and uniformity sought to be given them by punishments, they will try to avoid the punishment, but have no sense of shame.

“If they be led by virtue, and uniformity sought to be given them by the rules of propriety, they will have the sense of shame, and moreover will become good.”<sup>64</sup>

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**6.0.1** In many of the meetings I held during the course of the Review, I was frequently told about the views of the “audit profession” and the behaviour of those within that “profession”. However, surprisingly, no such profession formally exists. There is an accounting profession and individuals qualified within it can acquire the status of statutory auditor through a legal requirement for theoretical instruction, practical training, and maintaining their competence “at a sufficiently high level”. They must also be deemed to be “fit and proper” persons<sup>65</sup>.

**6.0.2** But auditing is not the same as accounting, and in the years ahead it will encompass even more. Furthermore, there are education and skills needed to conduct an audit that are not necessary to be an accountant. As my objective is to stimulate better audit, there needs to be much greater clarity about what an auditor is and to whom he or she owes a professional duty. Auditors need to be professionals in their own right, not just as a part of another profession.

**6.0.3** “Professionals are not merely individual agents isolated from others, accountable for only their individual acts.”<sup>66</sup> “Professional status carries with it role responsibilities that change the normal moral relations existing among members of society. Role responsibilities are responsibilities one has to take on such as a certain set of tasks in society, or perhaps by virtue of having been thrust not unwillingly into the position of assuming various tasks. That is, professionals are expected to carry out their tasks in ways that cause minimal harm to others.”<sup>67</sup> There should be a distinct corporate audit profession.

**6.0.4** I am grateful to Professor Andrew Likierman at London Business School for a most helpful submission to this Review<sup>68</sup>; in its focus on judgment his recommendations will sit very comfortably alongside the Principles which I enumerate later in the Report.

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<sup>64</sup> The Analects – 2, attributed to Confucius by Lao-Tse (USC US-China Institute website)

<sup>65</sup> CA06, Schedule 10, Part 2

<sup>66</sup> Bayou et al ibid

<sup>67</sup> Larry May, *Sharing Responsibility*; The University of Chicago Press (1992)

<sup>68</sup> Professor Andrew Likierman, *The role of professional judgement in improving audit quality* (July 2019) (see also Appendix 5)



**6.0.5** Today, the accounting bodies authorise the auditing firms who then present individuals for registration as auditors. However, Sir John Kingman has recommended that this function be no longer delegated to the professional institute, but should be taken on by ARGA itself. I agree with this conclusion.

**6.0.6** At the peak of this profession would be those authorised to sign an audit opinion; the profession would then define a series of layers of qualification for all those participating in an audit in a professional capacity (i.e. non clerical). New trainees would form the most junior of these layers.

**6.0.7** The unique blend of experience, technical expertise, professional judgment and ethical commitment required to sign an audit opinion should be the foundations of a highly respected role to which new recruits to the profession can aspire. I agree with the recent interim conclusion of the Netherlands Commission on the Future of the Accountancy Sector which stated: “the profession of auditor must become more attractive. Breaking the negative spiral into which the profession seems to have fallen is necessary. The profession itself is primarily responsible for providing an attractive environment for potential new auditors, and must address such crucial factors as work pressure, work-life balance and culture”. These factors were raised with my team in discussions with both younger people currently working in audit and younger people who left audit practice post-qualification.

**6.0.8** How would such a profession be established? Given that there is widespread concern that there has been a failure to respond to the anxieties laid out in the MacFarlane Report in 1992, it is unsurprising that there is consequent scepticism that such a fundamental reform would be successful if left to the accounting profession alone.

**6.0.9** In the first instance such a new profession for auditors would best be achieved by a statutory regulatory body establishing the rules. It may well be that, in due course, those authorised earn the right to organise themselves into a profession with various strands of specialisation and their own governance, the legitimacy of which would be bestowed on them by the regulator. The Government is committed to establishing ARGA and it would be appropriate for this body to establish the governance, setting of principles, education standards and authorisation of this new profession.<sup>69</sup>

**6.0.10** Accordingly,

**6.0.11 I recommend that ARGA acts as the midwife to create a new profession of corporate auditing, establishing the necessary professional body, to encompass today’s auditors and others with appropriate education and authorisation. ARGA would be the statutory supervisory body for that profession.**

**6.0.12** An example may help. Without taking sides in the debate around the value of Environmental, Social and Governance (ESG) measures or the way in which they are reported by directors, it is self-evidently desirable that the published data in this area is trustworthy. To achieve such trust, a framework of audit could be established to validate how the relevant data have been developed and the extent to which a professional eye views them as sufficiently fairly stated as to engender trust in the information they communicate.

<sup>69</sup> This is consistent with Recommendations 15 and 16 of the Independent Review of the Financial Reporting Council, *ibid.*

**6.0.13** The question then becomes who would provide that professional eye. The answer would be a suitably qualified member of the new corporate auditing profession. The landscape needs to be redefined as it is far from clear that an accountant is best placed to opine on many of the variables involved.

**6.0.14** The same framework would apply also to the auditing of the information contained in the financial statements of companies and financial statement auditors would continue to provide the scrutiny and opinion. Whilst in this new environment there may be environmental auditors, cyber security auditors and financial statement auditors, only some would need to have an accountancy qualification as known today. Those who are accountants would continue to owe a professional duty to the governing body of the accountancy profession, but as financial statement auditors their professional duty would be to the corporate auditing profession.

**6.0.15** In passing, I note that there is a current IAASB project on “Extended External Reporting Assurance” which has already used such terms as “financial statement auditor” and “EER assurance practitioner.”

**6.0.16** I recommend that there is one encompassing descriptor with a newly minted definition – “corporate auditor”.

**6.0.17** As indicated earlier, different levels of assurance for different matters would need to be defined within a new audit framework but, whatever levels are determined, they should be encompassed within overarching principles of corporate auditing.

**6.0.18** Without such an overarching framework and governance for the corporate auditing profession, any extensions of audit will simply be seen as the current dominant providers of audit seeking to find new revenue sources. Such a self-serving development, at a time when there is significant anxiety about the quality of work performed within today’s narrow definition of statutory audit, would be unhelpful.

## 6.1 Subject specific auditors

**6.1.1** Within the new profession of corporate auditing,

**6.1.2** I recommend that an auditor’s authorisation to carry out audits in particular areas of activity should flow from tailored qualifications which they have achieved.

**6.1.3** A useful analogy may be the driving licence which permits me to drive five of the possible fifteen classifications of vehicles.

**6.1.4** By giving ARGA the authority to establish this profession there is the prospect of changing the current landscape and bringing other participants into the audit market.

## 6.2 Establishing standards in new areas

**6.2.1** For new areas of auditing there will need to be the development of standards to facilitate comparisons. This new profession, working with ARGAs and users, will have an important role to play in this development. ARGAs will need to determine who the relevant standard-setting bodies

should be. Some areas have already begun to develop such standards. For example, JORC<sup>70</sup> in Australia appears to have assisted in creating confidence in estimates of mineral reserves.<sup>71</sup> JORC is not alone: for example, National Instrument (NI) 43-101 in Canada and the South African Mineral Reporting Code (SAMCODE) whilst, in Europe, ESMA endorses experts' reports that place reliance on the Committee for Mineral Reserves International Reporting Standards ("CRIRSCO"). There may be an opportunity, on the back of creating the new profession of corporate auditing, for ARGA to take a lead in coordinating such initiatives as CRIRSCO.

## 6.3 Establishing the role of Principles

**6.3.1** As I have said, in the course of gathering views it became clear that there is a widespread view that today's audit confines itself, inappropriately, to rules-following without taking wider views sufficiently into account.

**6.3.2** This is a sweeping generalisation and is not a criticism of all audit, but the strength of feeling is sufficiently strong that it feels well rooted in reality. As one individual described it "audit is like the high jump: the auditor attempts to clear the bar by the minimum possible distance lest any excess performance leads to new difficulties".<sup>72</sup> Another said "producer-led audit and producer-led standards are two sides of the same coin, and linked together have trapped audit into the 'correct by process and standards' approach that in turn has blunted scepticism and use of judgment."<sup>73</sup>

**6.3.3** Given this, I consider that it would be preferable to go back to the origins of Auditing Standards: they began as an extension of principles. These principles have increasingly become swamped by rules and although there was a development of an Auditor's Code, this has also slipped into oblivion<sup>74</sup>. I am in agreement that the present approach "hinders an auditor's ability ... in terms of discouraging sense-checking and makes it difficult for auditors to differentiate themselves other than on personality and price."<sup>75</sup> To guide all audit conduct, I consider there needs to be a set of clearly understood principles.

**6.3.4 I therefore recommend that the Principles of Corporate Auditing should be established to form an overarching framework governing the behaviour of corporate auditors, and that standards and rules should sit within this framework.**

**6.3.5 *Anyone authorised as an auditor should have a primary duty to behave in a manner that reflects these principles. I would expect that ARGA would then judge the quality of an audit, in part, as the extent to which the auditor's work and subsequent report are consistent with these principles.*** It is noteworthy that some recent FRC sanctions against auditors have been levied following charges brought under the accountancy ethical principles. This recommendation simply extends such principles to be more audit specific. ***Work conducted by an auditor faithfully adhering to these principles should then be such that a defence against action may become a principles-based defence.***

<sup>70</sup> Australian Code for Reporting of Exploration Results, Mineral Resources and Ore Reserves, promulgated by the Joint Ore Reserves Committee

<sup>71</sup> Submission from the Australian Institute for Performance Sciences (6 May 2019)

<sup>72</sup> CEO, Technology company

<sup>73</sup> Submission by Baroness Bowles (6 June 2019)

<sup>74</sup> Originally developed by the APB, the Code was withdrawn in 2016. The relevant 2015 Audit and Assurance Council minute says "on the basis that the substance is covered by the auditing and ethical standards and the Codes of relevant professional bodies, and there would be no regulatory risk associated with withdrawing the Code, the Council advised that the Code be withdrawn."

<sup>75</sup> Letter from Tim Ward, Chief Executive, Quoted Companies Alliance (23 July 2019)

**6.3.6** I note that Professor Karthik Ramanna supports the use of principles in his recent paper commissioned by PwC UK<sup>76</sup>. He particularly focuses on the development of the behaviours of auditors as individuals and the creation and maintenance of a culture of challenge.<sup>77</sup>

**6.3.7** I also note the remarks of Andrew Bailey<sup>78</sup> that “an organisation that prioritises being within the rules over doing the right thing will not stand up to scrutiny for long.”

## 6.4 Principles of Corporate Auditing

**6.4.1** It may be helpful here to set out a possible set of such Principles. ARGA will need to determine its process for establishing them.

**6.4.2** To fulfil the purpose of auditing:

- **Auditors act with integrity, fulfilling their responsibilities with honesty, fairness, candour, courage and confidentiality;**
- **Auditors are appropriately qualified and exercise professional judgment and appropriate scepticism or suspicion throughout their work;**
- **Auditors act in the public interest and have regard to the interests of the users of their report beyond solely those of shareholders;**
- **Auditors maintain independence from the entity and its officers on whom they are engaged to report;**
- **Auditors are objective and provide findings and opinions unaffected by bias, prejudice, compromise and personal or corporate conflicts of interest;**
- **Auditors work to verify and encourage openness and honesty in financial and other company reporting;**
- **Auditors ask the directors to report any material information that may legitimately be disclosed to assist the understanding of users of an audit report, and, if necessary, disclose it themselves;**
- **Auditors provide appropriate challenge to management, assessing critically information and explanations received for signs of over-optimism, judgmental bias or possible fraud;**
- **Auditors’ reports contain clear findings and expressions of opinion setting out all information necessary for a proper understanding of the opinion and its basis; and**
- **Auditors’ reports give transparency to any differences of view with management and how they were resolved.**

<sup>76</sup> Ramanna ibid

<sup>77</sup> “The demand for auditing in modern, complex economies arose from the recognition that managers of client organisations have incentives to manufacture favourable realities of their own performance and of the financial position of their companies. The role of the auditor is to probe those manufactured realities, to determine if they can be sustained in an objective truth – put differently, to ‘verify,’ which ... is to ‘make true’ such accounts by client managers. The core work of the audit is backward looking – it involves verifying past transactions for authenticity. But, critically, some of it is not – the audit also requires projection into the future, to test for the economic soundness of the client management’s assumptions. This is a question of judgement, where auditors can add great value to markets. Doing so requires professional scepticism, which is a questioning mindset. But it also requires a setting that allows individual audit professionals to exercise that questioning mindset: a setting that necessitates individual auditors to call on managers to prove or justify their judgements about realised and expected performance. Nurturing such a setting – a ‘culture of challenge’ – is one of the primary responsibilities of the audit firm. It is at the heart of how such firms add value in markets and organisations.” Ramanna ibid

<sup>78</sup> Chief Executive, FCA. Speech at The Future of Financial Conduct Regulation, at Bloomberg (April 2019)

**6.4.3** Such Principles will provide an overarching framework for the behaviour of auditors beyond that which simply follows standards and the law. More is required of auditors.

**6.4.4** In order that the Principles of Corporate Auditing are seen to be a living framework,

**6.4.5** I recommend that each audit report contains a statement to the effect that in conducting the audit the auditor has acted faithfully in accordance with the Principles of Corporate Auditing.

**6.4.6** To some degree this is about the ethics of the profession. It is, I believe, important to remember that law and regulations are not the only answer to ethical problems. The rule of law is of course essential, but ethics are driven by something more and should have an influence on behaviour that goes beyond compliance with rules. Indeed “the culture of challenge can and should exist within audit firms even without direct regulatory intervention.”<sup>79</sup> In developing these Principles regard should be had to the Code of Ethics for accountants developed by IESBA<sup>80</sup>, to ensure compatibility for those corporate auditors who will also be accountants, and also to the FRC’s ethical principles for auditors and the obligations under ISA (UK) 200 regarding professionalism and scepticism. Remarkably none of these refers to the public interest and IESBA’s recent proposal<sup>81</sup> to do so is therefore welcome.

## 6.5 Applying the Principles of Corporate Auditing

**6.5.1** The FRC has from time to time judged auditors’ conduct against “the standards reasonably to be expected of a member or member firm of the ICAEW.” I consider that such judgements will be stronger if the Principles of Corporate Auditing, recommended here, are applied directly to the auditor or audit firm.

**6.5.2** *All testing of the quality of an audit would start by assessing the extent to which an audit has been conducted in line with these principles.* These principles should free auditors from the mindset that a good audit is one which has only followed auditing standards to the letter.

## 6.6 Education and qualification

**6.6.1** Refocusing on Principles and professional judgment provides a good route to delivering proportionality and tailoring audit to the scale of the company in question. Moving away from the perspective of a process-led and rules-minded approach should enable a shift from one-size-fits-all to something much more informative and useful. This will require appropriate professional education and training.

**6.6.2** I therefore recommend that ARGA ensures that education, training and, if necessary, retraining, should take place consistently across this new profession.

<sup>79</sup> Ramanna *ibid*

<sup>80</sup> International Ethics Standards Board for Accountants

<sup>81</sup> “Proposed Revisions to the Code to Promote the Role and Mindset Expected of Professional Accountants”, IESBA Exposure Draft (July 2019)

**6.6.3** Auditor education needs to be focused and formalised. An auditor needs many skills that may not be essential for an accountant. For example, assessing trustworthiness requires psychological training alongside the development of the right balance between scepticism and suspicion. This needs to be tailored to the relevant environment and involves an understanding of both business and societal pressures on business.

**6.6.4** This is relevant not just to financial statement auditors but, as the scope of audit increases, will be particularly relevant for auditors whose subject areas are very focused. Each audit occurs in its own context and a deep understanding of that context is important if the auditor is to add value.

**6.6.5** Today, audit generally adopts a risk-based approach and depends on getting the risk assessment right. For financial statement auditors, that risk is the risk of the financial statements being materially misstated. For the future, auditors need to be educated in the ways in which risk can be manifested and assessed, not only on this narrow basis.

**6.6.6** Today's auditors acquire their statutory audit status from a system of delegated responsibilities, with the FRC as the "Competent Authority" and individual professional institutes as "Recognised Supervisory/Qualifying Bodies" responsible for ensuring compliance with the statutory requirements. An aspiring auditor follows a clearly defined path. For ICAEW<sup>82</sup> students/members it involves:

- Completion of the ACA (associate member) qualification (about three years) and a minimum of 2 years relevant post-qualification experience and evidence of continuing professional development (CPD); and
- Designation as a "Responsible Individual" by their employer and approval by the Audit Registration Committee.

**6.6.7** There is a time lag between passing the professional (ACA) exams and promotion to audit principal. During this period, aspiring auditors must comply with CPD and practical work experience requirements.

**6.6.8** CPD should involve more than refreshing and maintaining technical competence; again, the work of an auditor is conducted in a context and education about that changing context should also play a role. Professor Ramanna's report to PwC<sup>83</sup> points out that professional scepticism also has a cultural dimension.

**6.6.9** I consider that a key part of the education necessary to be a successful auditor is to be found in the current training afforded to forensic accountants. The psychology of suspicion that accompanies forensic accounting should be more widely taught, equipping auditors with the ability to choose between scepticism and suspicion in different circumstances.

**6.6.10** Academic research has described "the career step of the manager as a rite of passage" in which their previous identity (based on a linear, predictable career path) is destabilised and new practices (described as "performing, playing games and politicking") become more important in navigating the complex organisational network of a Big 4 Firm.<sup>84</sup> Research also suggests that

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<sup>82</sup> I have referenced ICAEW for simplicity of communication. ACCA, CAI, ICAS, and AIA are also responsible for professional qualification of statutory auditors in accordance with Schedule 11 of CA06

<sup>83</sup> Ramanna *ibid*

<sup>84</sup> Martin Kornberger, Lise Justesen, & Jan Mouritsen, *When you make manager, we put a big mountain in front of you: An ethnography of managers in a Big 4 Accounting Firm*; *Accounting, Organizations & Society*, 36(8), 514-533 (2011)

some individuals who left the audit career track found the tension between their professional self-image and the commercial demands placed on (aspiring) audit partners particularly difficult to accept.<sup>85</sup>

**6.6.11** Again, this illustrates the need for an all-round education to ensure the emergence of well qualified auditors. As audit stretches across more areas than just financial statements so this need for a base level qualification will become more important. Whilst for today's auditors, credits may be given for existing training, in other areas this opportunity for education may not be as well developed. Working with relevant bodies, **ARGA will need to help develop satisfactory curricula and establish mechanisms for qualification.**

**6.6.12** Consideration of these educational needs suggests that there is a challenge waiting for academia to develop appropriate degree courses (possibly post-graduate) for auditing and assurance. The Review has come across only a handful of university courses in the world (e.g. in Germany, Chile and Jordan) dedicated to auditing, although the study was not exhaustive. The Review did not find any course in the UK dedicated to a generalist teaching of audit. Such post-graduate education as exists is narrowly focussed on subjects such as clinical auditing.

**6.6.13** To ensure appropriate qualifications,

**6.6.14 I recommend that the development of a specific auditor qualification, including education and training, should become a high priority for ARGA over the coming years.**

**6.6.15** Professor Likierman argues that as judgment permeates audit, it is essential that the profession coalesces around an agreed definition of professional judgment. He points out that the term does not “mean the same in all parts of the accounting profession. Perhaps this is not surprising, since there are many different definitions of a profession and not just in accounting.”<sup>86</sup> It would be helpful for ARGA to revisit its definition of professional judgment.

**6.6.16 I recommend that ARGA develops an agreed definition of professional judgment which builds on ISA (UK) 200.**

Auditors should describe the significant judgments that they make.

**6.6.17** Likierman proposes such a definition as “The combination of personal qualities, relevant knowledge and experience with professional standards to make decisions and inform opinions.” Clearly ARGA would have to test this definition to gain appropriate support and develop supporting guidance.

**6.6.18** He continues “just as a definition is necessary to know what is being addressed, so, in seeking to take steps to improve the standard of professional judgement and mitigate risk, it is necessary to provide an analysis to know what can be improved”<sup>87</sup>. He then breaks down professional judgment into its constituent elements and concludes that this analysis can form the basis for “guidance and practice notes provided by firms for their staff” making clear what professional judgment is and providing a framework of how to use it.

<sup>85</sup> Laurence Daoust & Bertrand Malsch, *How ex-auditors remember their past: The transformation of audit experience into cultural memory*; Accounting, Organizations and Society, 77 (2019)

<sup>86</sup> Likierman *ibid*

<sup>87</sup> Likierman *ibid*

**6.6.19** I will discuss technology more generally later, but it is worth noting now that the ubiquity of technology within audited entities will demand more technological education of auditors. At the same time the advent of technological routes to assessing data should reduce some of the duller aspects of the junior auditor's current role. This offers an important opportunity for training to be more focused on value adding activities.

## 6.7 Education of corporate executives and non-executive directors

**6.7.1** During an audit engagement it is important not just that the auditor behaves according to a set of professional principles but that the corporate executives with whom they interact also understand the role, purpose and operation of an audit. I encountered examples of junior executives in companies being audited having impatience with the auditor's team and being prone to demand turnaround times that were incompatible with the principles that the auditor should be following.

**6.7.2** To the extent that those in companies who interact with auditors in this way have a form of accountancy qualification, I recommend that the accountancy bodies incorporate education in auditing to ensure a better understanding of the respective responsibilities of the company executive and the auditor. The accountancy bodies may also choose to offer training, tailored accordingly, to non-accountants within companies who deal extensively with the auditor, including non-executive directors.

## 6.8 Acting in the Public Interest

**6.8.1** Auditors cannot act alone in the public interest; they need directors to do so too. To help create a framework for a new form of public interest reporting which would enhance the value of the audit, I asked Dr Carien van Mourik<sup>88</sup> and Professor Chris Humphrey to consider how a statement of public interest might be made and how it might be audited. I believe this is consistent with helping audit to be a more informative process and product whilst not losing the benefits of its compliance aspect.

**6.8.2** I am hugely grateful to them for their work which results directly in the following two recommendations. The responsibility for these recommendations is mine alone. As they are built on their work, I have reproduced in Appendix 6 their supporting paper. This explains their focus on PIEs and possible changes required, presents a draft Public Interest Statement ("PIS") and discusses related disclosures by the directors, presents a draft auditor's Statement (to be included in the audit report) regarding the directors' PIS, and introduces the idea of a Public Interest Audit Committee.

**6.8.3** In publishing their note, I wish to be clear that not all of it accords with my views. For example, the suggestion to require the creation of such Public Interest Audit Committees is, I consider, a disproportionate step and is beyond the scope of the Report. Furthermore, in this Report I have chosen not to contribute further to BEIS' work on the definition of a PIE.

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<sup>88</sup> Lecturer in Accounting, The Faculty of Business and Law, The Open University.



**6.8.4** The conclusions, however, are wholly compatible with the desire for more informative reporting in the interest of users. The concept of a public interest statement is useful, bringing together as it does relevant parts of Companies Act reporting under s172<sup>89</sup> and s414CB<sup>90</sup>. Therefore,

**6.8.5** I recommend that the directors should set out in a Public Interest Statement (as part of the Strategic Report) how they view the company's legal, financial, social and environmental responsibilities to the public interest. This Statement should explain how the company has discharged its self-declared public interest obligations and responsibilities, what actions it has taken to mitigate any externalities it has caused during the period, and how effective these actions have been.

**6.8.6** And,

**6.8.7** I recommend that the audit report should state the extent to which the audit has yielded sufficient evidence of consistency between the content of the Public Interest Statement and the Annual Report and Accounts as a whole. The auditor's opinion should state whether, based on the evidence reviewed, the directors' Public Interest Statement is presented fairly in all material respects.

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<sup>89</sup> s172 CA06: Duty to promote the success of the company (including obligations on directors to have regard to certain other interests in doing so). See section below on 'Stakeholders'.

<sup>90</sup> s414CB CA06: Non-financial information covering, as a minimum, employee, environmental and social matters, respect for human rights and anti-corruption and bribery policies.

## 7. Quality of Audit

**7.1** This Report refers specifically to audit quality and audit effectiveness. I have chosen to consider the latter as largely defined around the process of audit, whilst the former, more holistically, includes the output. There are many descriptions of the quality of audit, many with desirable, but not sufficient, characteristics. I set out several here:

i. The CFA Institute has defined a high-quality audit as follows:

“A high-quality audit is one that diminishes the ability of a management team to obscure the economic reality, and one which ensures the timely communication of information which could become significant if the future state turns out to be different to reporting date expectations.”<sup>91</sup>

I would add the ability of the board to seek to obscure economic reality should also be constrained by a high-quality audit.

This definition is useful because it emphasises very clearly that the purpose of audit should be to inform and not just to check compliance. Other things being equal the more informative the audit report the higher quality it is likely to be. Indeed, my objective is to help audit to be better and more informative.

ii. The Quoted Companies Alliance (QCA) defines a high-quality audit as one which will:

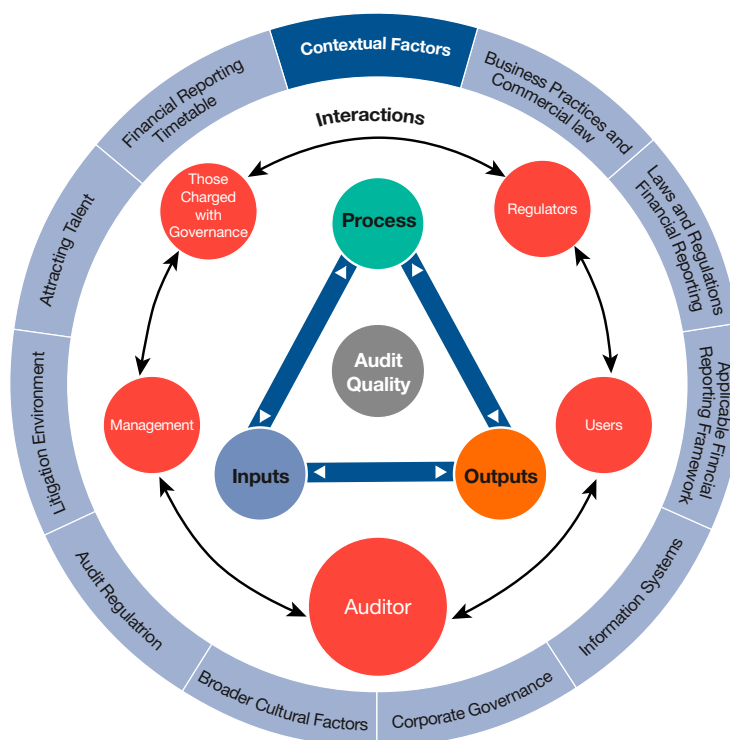
- be tailored to the risks facing the company, its business and the regulatory environment;
- be undertaken by an audit team that is technically strong, perceptive, independently minded and sceptical;
- be appropriate for the control environment and the IT systems used in the financial reporting and control process;
- include reports to the audit committee that reflect the audit team's thought processes, and rationale for conclusions, and provide the auditor's views and insights on governance and control matters;
- ensure effective interaction with management and the audit committee throughout its performance; and
- contribute to the accounts being an effective communication tool.<sup>92</sup>

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<sup>91</sup> *Economia, Why Audits are not meeting investor expectations* (August 2019)

<sup>92</sup> QCA Audit Committee Guide (2019)

- iii. The CMA in its April 2019 report states that “we have defined audit quality with reference to the academic literature and the views of stakeholders.” Their definition includes “the need for an experienced and properly resourced audit team to display sufficient scepticism, objectivity, integrity and independence in their work, as well as to appropriately challenge management with a well evidenced report despite the strong pressure to conform to their judgements.” They go on to say that a quality audit needs a high-quality governance environment in the audited entity to succeed.<sup>93</sup>
- iv. The FRC<sup>94</sup> says that “high quality audit provides investors and other stakeholders with a high level of assurance that the financial statements of an entity give a true and fair view, and provide a reliable and trustworthy basis for taking decisions.” A quality audit also needs to be “driven by a robust risk assessment informed by a thorough understanding of the entity and its environment, and provides challenge, transparency and insight in a clear and unambiguous way. It should also provide a strong deterrent effect against actions that may not be in the public interest, underpins stakeholder confidence, and drives continuous improvement.”
- v. The IAASB<sup>95</sup> visualises a framework for quality audit thus:



and states that a quality audit is likely to have been achieved by a team that:

- exhibited appropriate values, ethics and attitudes;
- was sufficiently knowledgeable, skilled, and experienced and had sufficient time allocated to perform the audit work;
- applied a rigorous audit process and quality control procedures that complied with law, regulation and applicable standards;
- provided useful and timely reports; and

<sup>93</sup> CMA *ibid*

<sup>94</sup> *Developments in Audit*, FRC (2017)

<sup>95</sup> *A Framework for Audit Quality*, IAASB (2014)

- interacted appropriately with relevant stakeholders.

**7.2** It is a daunting assignment to attempt to unify these definitions (and many others) but one way would be to break the audit down into different strands and achieve a definition for each. Most existing definitions confuse ethics, operations, judgments, outputs and effectiveness.

**7.3** This is more than just semantics. It is important because all around the world there is a clamour for higher quality audit and it is not unreasonable for auditors to want to know what this means. As audit extends beyond just the audit of financial statements, as argued in this Report, so the definition of a quality audit will have to stand well in relation to new areas also.

**7.4** *ARGA should endeavour to achieve a unification of definition.* My suggestion, which could be taken forward by ARGA immediately, is:

A high-quality audit is one which:

#### **Ethics:**

- is conducted fully respecting the Principles of Corporate Auditing.

#### **Operations:**

- is based on a clear plan which in turn is based on an accurate and efficient identification of the risks affecting the variables to be audited;
- applies all necessary, appropriately qualified resources – technically strong, perceptive and independently-minded – to the conducting of the audit;
- documents in an effective but proportionate way the steps taken to reach conclusions; and
- takes advantage of new technologies to improve the probability of its judgments being appropriate.

#### **Judgments:**

- involves the application of scepticism throughout and suspicion where appropriate;
- makes judgments based on tested information; and
- makes judgments that remain appropriate in the light of subsequent events that were reasonably predictable.

#### **Outputs:**

- informs stakeholders in a decision useful manner; and
- reports faithfully to the audit committee all material disagreements with management, whether resolved or not.

#### **Effectiveness:**

- diminishes the ability of management or the board to obscure the reality of the company;
- provides a reliable and trustworthy basis for taking decisions; and
- acts as a strong deterrent against other actions that may not be in the public interest.

## 8. Shareholders and other stakeholders

### 8.1 An Agency Problem

**8.1.1** Shareholders are typically seen as ‘primary users’ of the financial statements, and by extension of the audit report. This is reflected in UK company law, which requires the auditor to report to the ‘members’ of the company, that is, those shareholders named on the company’s share register.

**8.1.2** Yet the names on the share register generally do not fully reflect the multitude of underlying interests invested in a company. As evidenced in the Kay Report<sup>96</sup> in 2012, the chain of investor participants is typically long and complex, with numerous intermediaries between the private individuals originally providing the money for the investment, and the company which uses the resulting investment.

**8.1.3** To simplify, members of the public may invest their cash, for example, in a pension fund, which is then overseen by trustees who curate the investment and who generally delegate the day-to-day management to a professional who in turn seeks the advice of an investment adviser who in turn helps in the selection of an asset manager who then invests the pension fund members’ monies in various companies, and has responsibility for helping to appoint and monitor the performance of the directors of the company. Sometimes the investment manager invests through another vehicle managed by yet another manager.

**8.1.4** In such an intermediated investment chain, it is not easy to say with certainty who the true consumers of the audit product are, and how their interests may be represented effectively by the auditor. The matter is complicated further by the fair claims of several other groups to be audit consumers. International accounting standards also recognise creditors, lenders and potential investors as primary users of the financial statements. Audited companies and regulators have a clear interest too. And the interests of other stakeholders – including a company’s employees, suppliers and customers – are also increasingly cited as being dependent in some way on the audit.

**8.1.5** In this complex chain, there is a further layer of delegation of responsibility from the investor to a board of directors who have responsibility to monitor the management, a responsibility in relation to audit discharged through a sub-group of the board, the audit committee, made up of non-executive directors. Once funds have reached the company the board becomes the steward of the investment.

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<sup>96</sup> Prof John Kay, *The Kay Review of UK Equity Markets and Long-term Decision Making* (July 2012)

**8.1.6** Proxy advisers have become influential voices in this landscape. One other layer complicates the picture further with the institutional investors' interlocutors with the board often coming in two different guises: one as corporate governance specialists and the other as portfolio managers.

**8.1.7** There are also private shareholders either holding their investments directly or through financial advisers.

## 8.2 Producer-led audit

**8.2.1** With such a variety and incoherence of consumer voices and interests, it is perhaps not surprising that audit has continued to develop primarily as a producer-led product. The producer-led nature of audit is reflected in the fact that its international standard setting body, IAASB, is still linked to the International Federation of Accountants. That relative lack of independence from the global accounting profession continues despite it being over two years since the Monitoring Group of the world's financial regulators (including IFIAR, IOSCO, the Basel Committee on Banking Supervision, the Financial Stability Board and the World Bank) sought views about how the independence of the international audit-related standard setting boards could be enhanced.

## 8.3 Asset managers

**8.3.1** It is important that this producer-led status quo in audit begins to shift so that the consumer voice is heard more clearly. In this respect, the asset managers who are on the frontline of company reporting, and who typically are the formal recipients of the audit report, have an important role to play. It is not fully clear to me, though, that all asset managers are giving audit the focus and attention that it deserves<sup>97</sup>.

**8.3.2** For example, recent work by EY<sup>98</sup> suggests that asset managers and asset owners rank audit and assurance seventh out of eight stewardship categories in importance, with areas such as executive remuneration attracting considerably more time and energy in investor engagement with companies, and in the development of investor guidance. I was also rather underwhelmed during the Review by the interest in audit shown by some of the portfolio managers with whom I spoke. Few appeared to read the audit report thoroughly and several took the view that it was enough to know whether or not the auditor had given an unmodified opinion.

**8.3.3** Memorably, one senior fund manager noted to me that investors increasingly rely on machine reading of audit reports. This innovative use of technology is perhaps understandable given the very many audit reports that the typical index investor is faced with each year. But it does call into question whether the reporting of auditor judgment and scepticism is being carefully considered.

**8.3.4** Stepping back, the relative under-engagement with audit by some institutional investors seems to chime with wider concerns about how well-equipped some shareholders, tracking an index, may be to hold both companies and auditors to account. Martin Wolf put it well: "How can long term trust be sustained if the constantly reiterated aim of the corporation is to serve the interests of those least committed to it, while control is also entrusted to those least knowledgeable about its activities and at least risk of damage from its failure?"<sup>99</sup>

<sup>97</sup> Drs Suzanne Morsfield and Alison Thomas, *A Survey of Investors*; commissioned by this Review. This research was interview-based, independent and unpublished. "36% of the buy-side...always or usually read the audit opinion"

<sup>98</sup> EY, *Turning the Tide to Greater Corporate Accountability* (2019)

<sup>99</sup> Martin Wolf, *Rethink the purpose of the corporation*; The Financial Times (11 December 2018)

**8.3.5** *I consider that more can be done to ensure that shareholders, including asset managers, have the opportunity and incentive to engage more meaningfully with individual audits, and with ongoing wider issues of audit quality.* In section 9 of this Report, I suggest ways in which this could be done.

## 8.4 Stakeholders

**8.4.1** As if this background was not complicated enough, there is now legitimate and widespread pressure, as discussed, to include the interests of a wider group of stakeholders. Alongside greater engagement by shareholders, I consider there is greater scope for the audit report to serve the interests of other stakeholders, including those of the company's employees, customers and suppliers. The interests of these stakeholders in the actions taken by directors is already established through the annual reporting duty laid on directors to state how they have met their obligations under s172 CA06, taking into account the:

- likely consequences of any decisions in the long term;
- interests of the company's employees;
- need to foster the company's business relationships with suppliers, customers and others;
- impact of the company's operations on the community and the environment;
- desirability of the company maintaining a reputation for high standards of business conduct; and
- need to act fairly as between members of the company.

**8.4.2** To help ensure that company reporting under this new obligation is done with integrity and meaning, and to give assurance beyond that found in board and committee minutes,

**8.4.3** *I recommend that the audit report should include a new section in which the auditor states whether the company's section 172 statement is based on observed reality, on the basis of the auditor's knowledge of the company and its processes.*

**8.4.4** It is possible that, in response to this recommendation, auditors may yet again seek to develop standards but, to achieve the objective of enhancing information, their action needs, instead, to flow from the Principles of Corporate Auditing. Holding themselves to this higher obligation, they should be quite capable of providing such information as they, using their judgment, deem to be useful, without the need for new standards.

**8.4.5** Responding to the needs of stakeholders in this way is part of restoring trust in business.

**8.4.6** The effects of the 2008 financial crash cast a long shadow forward. Trust in leaders and in business itself appears to have fallen: 52% of the public believe that the way business works today is not good for society.<sup>100</sup> In consequence each failure of a business becomes magnified in terms of the analysis of its impact and the mood is that someone must be to blame. It is not, however, auditors that cause corporate failures; that responsibility lies with the directors who may or may not have been able to take evasive action. Nevertheless, an ineffective audit can contribute significantly to the collapse of a company if the consequence is that warning signals that could have resulted in successful mitigating actions were not communicated in time, or with sufficient clarity, to either directors or shareholders.

<sup>100</sup> 2019 Edelman Trust Barometer

**8.4.7** In determining the scope of the auditing required, conclusions need to be drawn about the extent to which trust is placed in the directors' truthfulness, or where there are no absolute truths, their judgment. In practical terms these judgments need to be made by shareholders (or their agents) despite all the imperfections that follow as a result of the agency problems outlined above. In some instances, there may be a case for other interested parties to bring pressure on the regulator to seek further audit, but the bar for such pressure to be successful would need to be set very high.

**8.4.8** The demands for reporting to wider stakeholders is only likely to increase in future both in the UK and internationally. The US Business Roundtable's<sup>101</sup> recent statement committing major US corporates to address explicitly the interests of a wider group of stakeholders, alongside the shareholder interest, is just one example of the trend.

**8.4.9** I consider that these demands will help audit further to act in a way which also serves a wider public interest. As the FRC stated last year: "Audit is a public good – it gives stakeholders confidence in the integrity of financial information in the capital markets which forms the basis for investment decisions. Audit also provides valuable assurance to company boards about the integrity of the entity. A well run, transparent and accountable business not only generates a return on capital to fund more investment, but also gives employees confidence that their jobs and pensions are secure, and suppliers confidence they will be paid."<sup>102</sup>

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<sup>101</sup> <https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans>

<sup>102</sup> Financial Reporting Council, *Developments in Audit* (2018)



## 9. Engaging the Shareholders

**9.0.1** Notwithstanding the agency problems already referenced, there is widespread agreement that more, but proportionate, engagement by shareholders, whether as direct owners or asset managers, would help with establishing trust. At the same time care needs to be taken in this area, as investment managers frequently may not possess the skills to understand the detailed day-to-day management and operational issues facing many companies. Engagement beyond their competence would be worse than none at all. It is noticeable that there has developed a sense that all engagement is good and non-engagement is bad. I do not agree.

**9.0.2** Investment managers are curators of the underlying savers' assets; they rely on the directors who are the stewards, particularly on behalf of shareholders, of the companies in which they invest. I believe that it can be just as appropriate for investment managers to disinvest from a company as it is for them to expend resources on trying to influence it. This matters, as the form of any engagement by shareholders with audit needs to be structured so that it does not demand involvement beyond that which the investment manager is competent to achieve.

### 9.1 Risk Reports as a point of engagement

**9.1.1** The starting place for this engagement should be the risk reporting by the directors<sup>103</sup>. Currently the Statement on Principal Risks and Uncertainties ("Risk Report") is published as part of the Annual Report and therefore is read contemporaneously with the result of the audit. This has no logic. It would be preferable that the opportunity exist, before the audit committee has endorsed the audit plan, for any views of shareholders, informed by the latest Risk Report, to be taken into account.

**9.1.2** I am encouraged that almost half of investors surveyed for the Review<sup>104</sup> were of the view that the ability to engage in advance of the audit plan being agreed would be useful.

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<sup>103</sup> "The board should carry out a robust assessment of the company's emerging and principal risks. The board should confirm in the annual report that it has completed this assessment, including a description of its principal risks, what procedures are in place to identify emerging risks, and an explanation of how these are being managed or mitigated." Provision 28, UK Corporate Governance Code (July 2018)

<sup>104</sup> Morsfield & Thomas, *ibid*

9.1.3 Accordingly,

**9.1.4 I recommend that the directors' Risk Report should be published prior to the audit committee meeting at which the scope of the next audit is determined and endorsed, leaving sufficient time for shareholders to comment. Alongside, the audit committee should publish a formal invitation to shareholders to express any requests they have regarding the areas of emphasis they wish the auditor to incorporate in the audit plan. The audit committee should state the auditor's proposed materiality levels for the forthcoming audit with this invitation.**

9.1.5 Thus, the Risk Report would be published around the middle of the company's year in the first instance. It should be made clear that this report has not been audited but,

**9.1.6 I recommend that, if the auditor considers there are other risks of similar or greater significance to those reported by the directors, based on its knowledge of the company, the auditor should report this fact.**

9.1.7 Enlightened companies may choose to engage shareholders on this Report through hosting a chat room environment in which shareholders could see each other's views and the company's responses.

9.1.8 It would be desirable if the Risk Report was published separately from any interim results reporting. The latter would of course be able, in unchanged circumstances, to make use of the Risk Report. An updated version of the Risk Report would still be published in the annual report and accounts, although for most companies this would need little amendment from that published earlier in the year. Thus, given that the Risk Report is based on continuous work in any event, the extra burden for companies from this earlier publication date should be very small.

9.1.9 I support the comment from the ACCIF that ***"there needs to be more colour provided on the principal risks over and above simply a list of what they are. The focus should be on specific risks that remain after taking account of the controls and mitigations in place, [users] want to understand how those risks have changed from the prior year."***<sup>105</sup>

9.1.10 The audit committee would then consider any such shareholder requests for emphasis and share them with the auditor, (wholly or selectively, with their reasons for not selecting any given in the annual audit committee report), but with the auditors ultimately having discretion to accept or reject the requests. I suspect it would take a brave auditor to reject shareholder suggestions endorsed by an audit committee. Accordingly,

**9.1.11 I recommend that the audit committee and the auditor be required to publish the reasons why they accepted or rejected any such requests in their Reports.**

9.1.12 In considering this approach, I encountered quite arcane discussions about who "owns" the audit plan. It is important to understand that there may be a shift in "ownership" implicit here. Today, the auditor has "ownership"<sup>106</sup> of the audit plan which is approved by the audit

<sup>105</sup> Letter to Review, from ACCIF (November 2019)

<sup>106</sup> "While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility, to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence." ISA (UK) 260

committee. It should fit inside the Audit and Assurance Policy of the company (see following section of this Report). Thus, at a high policy level the audit committee would “own” the plan. The auditors would, of course, own the detailed implementation plan of their own audit work.

**9.1.13** It will be necessary to consult shareholder bodies over which type of requests deserve formal consideration. One way to do so would be in relation to the scale of the equity holding(s) making a particular request. Another would be a materiality test. Ideally all such qualifying requests would be published alongside the response, so that any outliers are transparent and may provide an early warning signal, even if not coming from a significant portion of the equity.

**9.1.14** When inviting requests from shareholders the following questions would be examples of what may be asked:

- are there other risks that ought to have been considered in devising the plan?
- are there other activities in the company over which shareholders want more assurance than planned, insofar as they contribute to the integrity of the financial statements?
- are the levels of materiality proposed appropriate or what alternative is proposed?

**9.1.15** With such requests, those shareholders, who wish, will have the opportunity to influence the shape of the audit plan given their knowledge of the risks facing the company. For example, in the case of Carillion, given the stated scepticism some shareholders had about the company’s contract accounting practices, they would have had the opportunity to reference their concerns in a way that may have led to a stiffening of the resolve of the auditor to call out any marginal anxieties in its audit report and would have made it hard for management to refuse to engage meaningfully on the issue.

**9.1.16** I fully understand that there is nothing to stop shareholders making such requests today. However, they rarely do. The process I recommend would have the twin advantages of creating more awareness, earlier, of the risks the directors foresee, and making less likely assertions that shareholders knew all along that something was not right but had done nothing about it.

**9.1.17** It would also be open then to any audit committee to choose to publish its audit plan (which of course would provide for an element of unpredictability) before the audit begins. In any event the key emphases in the plan should form part of the audit committee’s annual report: this may involve both breadth and depth. As audit is today it would be confined to the work to assure the financial statements. Thus, breadth would refer, for example, to the geographical spread of the work required and depth would relate, for example, to the levels of materiality viewed as appropriate in testing. A clear justification should be given for the levels of materiality chosen for different types of audit.

## 9.2 Beyond the statutory audit

**9.2.1** So far, I have largely confined these comments to today’s statutory audit of the financial statements.

**9.2.2** In the world of audit beyond today’s statutory audit, a similar process for setting scope would be followed. Here the breadth of the discretionary audit scope would be proposed by the audit committee in the same way. Now, at the same time, it would be open to the audit committee to indicate its intention that CO<sub>2</sub> emissions, or published oil reserves, for example, are to be subjected to an audit process. This will become of increasing importance as carbon constraints are introduced in response to climate challenges, and, given the additional reporting requirements that may arise in response to the Task Force on Climate-related Financial

Disclosures (“TCFD”), it is likely that greater weight will be placed on such disclosures in the future. As with the auditing of the financial statements, it would be made clear who would carry out the relevant work. Such auditors would, of course, be authorised to do so within the new auditing structure but, to be clear, they need not be the currently authorised auditors.

**9.2.3** Here too, the audit committee invitation to shareholders would include reference to the information which they wish to have audited and in what manner. Again, the audit committee would justify in its annual report why it rejected (or accepted) particular proposals<sup>107</sup>.

**9.2.4** By proceeding in this way the risk of incurring disproportionate costs would be avoided as, first, the shareholders’ views would be advisory only, and to the extent that they feared unnecessary cost they would be inhibited from making proposals other than when they considered the benefits of the audit would outweigh the costs. I consider that this framework would also act as an incentive for information to be “right first time”, thereby not requiring layers of assurance. Whilst there would be some extra work for audit committees, I am persuaded that this is work by and large which they should be doing in any event. Thus, shareholders who wish to influence would have a formal opportunity to do so, their involvement would be transparent and by leaving the audit committee to determine the way forward, the authority of the board as steward would not be undermined.

## 9.3 Avoiding an everything-must-be-audited culture

**9.3.1** I received a considerable number of requests to extend audit to cover many other pieces of information beyond those contained in the financial statements. Much of this is understandable as society seeks increasingly to fit business into a role having wider responsibility. Many want to be sure that the information on which they base judgments is reliable.

**9.3.2** There is a trap here. The most efficient economic system will derive from a do-it-right-first-time culture avoiding the necessity to employ layers of checking. I do not want audit to be used as an excuse for less rigorous decision making and information sharing in the first instance, as those responsible rely on the auditors to correct errors. Nor do I want a checking culture to pervade all of business. That is why good controls are so important.

**9.3.3** Consequently, I have framed recommendations, in many instances, to leave the power of decision making in the hands of those using and paying for audit services, in particular the shareholders, as primary users of audit. It seems to me that those are the people most likely to want their audit to be cost effective and least likely to seek to extend audit beyond a point at which it adds value.

## 9.4 Audit fees

**9.4.1** I found consideration of the process of engagement with the auditor to be most instructive with very unclear processes for auditor objective setting, plan determination and fee setting by most audit committees. In general, whilst there are honourable exceptions, I found management to be the first line of negotiation, as to both scope and fees, with audit committees generally blessing the outcomes rather than having an active involvement in the process.

**9.4.2** It was startling to find that in some companies the audit fee forms part of the finance function budget, creating two clear conflicts of interest for the CFO: first, in trying to minimise the fee in order to gain extra resource for other finance function activity and to control the

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<sup>107</sup> As before, there would need to be agreed thresholds.

amount spent, and second, in influencing the extent of the checking on his or her function and performance.<sup>108</sup> Although relatively small, the audit fee also impacts the base for incentive compensation today.

**9.4.3** There is disturbing academic evidence based on data from the United States (I am unaware of a parallel study in the UK) that infers that auditors are punished (for instance through lower fee growth) where they have been stricter<sup>109</sup> in their assessment “undermining the idea of a healthy market for audit in the absence of additional independent checks on client management.”<sup>110</sup>

**9.4.4** Whilst in many companies the fees may be de minimis in relation to the whole,

**9.4.5 I recommend a change in the law to require the audit fees to be shown on the face of the profit and loss account as being struck, like the dividend, after the reporting of post-incentive compensation profit.**

**9.4.6** Publishing the audit fees in this way, rather than as now buried in the notes to the profit and loss account, would make it unambiguously clear that the fees are costs incurred by the company at the behest of the audit committee and paid for by shareholders.

**9.4.7** I have been told that amending the face of the P&L in this way would mean that the auditors could no longer give an unmodified opinion about the extent to which the accounts conform with IFRS. It is beyond the scope of this Review to attempt to change IFRS, but I do not believe that it would be difficult to devise a simple statement to the effect that the accounts comply with IFRS “with the exception of the treatment of the audit fees”. If all accounts had the same comment it would not detract from their validity. In some instances, the audit fees may not meet a materiality threshold in any event. Such a change would be insufficient importance to make it impossible to state that the accounts are presented fairly.

**9.4.8** Transparency could only help to cleanse the relationships and improve confidence.

**9.4.9 I recommend that the audit committee chair should be delegated to negotiate the fees for the relevant audit work. The Board, as a whole, should agree a budget for the audit committee – the assurance budget – within which the fees would be included.**

**9.4.10** That budget should encompass any other work the audit committee wishes to have undertaken on its behalf.

**9.4.11 *Once the audit committee has agreed the fees, they (and any other expenditure incurred by the audit committee) should be made visible in the accounts and required to be justified in the audit committee report.***

**9.4.12** There is one other aspect of the fee setting which I find surprising. The fee is typically negotiated by the partner leading the audit. The profitability of the audit therefore depends on the person who is leading its planning and execution. This sets up a conflict of interest which may manifest itself when an audit gets “difficult”.

<sup>108</sup> As described to me by a FTSE-100 company

<sup>109</sup> Christopher Bleibtreu and Ulf Mohrmann, *Do Audit Clients Prefer Watchdogs or Lapdogs? The Effect of Strictness on Audit Offices' Market Shares* (July 2019) and Elizabeth Cowle and Stephen Rowe, *Don't Make Me Look Bad: How the Audit Market Penalizes Auditors for Doing Their Job*; University of Arkansas (September 2019)

<sup>110</sup> Ramanna *ibid*

**9.4.13** A better process can be learned from the way in which fees are set by the ratings agencies. Here ESMA and IOSCO rules insist that the setting of fees is handled wholly separately, on behalf of the agency, by a team that is independent of the rating setting process. In this way, if a difficult issue emerges, there is less temptation to bury it on the grounds that further work would eat into the profitability of the engagement.

**9.4.14** I recommend that, similarly, audit firms establish an independent fee-setting function making its decisions separately from those conducting the audit.

## 9.5 General Meetings

**9.5.1** There are mixed views about the value of General Meetings as venues for communication. Nonetheless they are established and can act as important safety valves. Some may increasingly be held as virtual meetings using communications technology.

**9.5.2** They provide an opportunity, currently not taken, to ask auditors questions. Some shareholder respondents considered there was value in a meeting just with the auditors, but to maintain proportionality, using the existing Annual General Meeting seems a more cost-effective approach. The opportunity to question the auditor would be a natural conclusion to the process begun by inviting shareholder views on the audit plan.

**9.5.3** s502 CA06 gives the auditor the right to attend and “be heard” at the company AGM. It is an interesting question why so few take up this right.

**9.5.4** It is already expected in the UK that the audit committee chair will attend the AGM and respond to any relevant questions from shareholders. I believe that the relevant Senior Statutory Auditor should also attend, and be prepared to respond to questions. Where an auditor has given a modified opinion, the audit committee chair should be expected to make a direct comment on the reason for the modification and any changes that the company has made, or intends to make, as a result.

**9.5.5** Consequently,

**9.5.6** I recommend that a standing item be added to AGM agendas: questions to the chair of the audit committee and to the auditor.

## 9.6 Institutions and Implementation

**9.6.1** One of the antecedents of this Review is the Audit Quality Forum, a loose grouping of interested parties, chaired by a senior auditor and designed to promote discussion and raise issues of audit quality with a view to stimulating improvement. It was established in 2004.

**9.6.2** Like so many other parts of the audit ecosystem, it has been driven (some have said, directed) by auditors and whilst serving as a useful stimulus, and involving the FRC and, to some extent, BEIS, it has no teeth, represents no clear interest and is seen as an, albeit helpful, “talking

shop”. I have no doubt that it has been a well-intentioned endeavour but it is now representative of a past era. It is time for the users of audit to step up and create a well-structured body with a formal link to ARGA to make clear recommendations for the improvement of audit.

**9.6.3 I therefore recommend that a new body – the Audit Users Review Board (“AURB”) – be established, comprising solely users of audit reports, to review proposals from and give advice to ARGAs as to the evolution of audit.**

**9.6.4** Ideally the Investment Association would provide the secretariat, working with at least the Audit Committee Chairs Independent Forum (ACCIF) and The 100 Group as well as representatives of shareholders, including retail, and other users. The funding of this body should be shared between its participants. It should be independent of auditors.

**9.6.5** At the same time auditors themselves may wish to consider mirroring the US Center for Audit Quality, which is linked to the AICPA and funded by the public company auditors it represents. The creation of such a body would be assisted by the recommended establishment of a new auditing profession. Both proposals for AURB and such a Centre would have the very considerable merit of making it unambiguous who is driving the agenda – users in one case and producers in the other. As the Big 4 have shown during the course of this Review, they are perfectly capable of ensuring dialogue between the two.

## 10. An Audit and Assurance Policy

**10.0.1** It is now six years since the introduction of the requirement for a remuneration policy on which shareholders vote at least once every three years. This has increased the dialogue with investors and focused boards and remuneration committees towards greater clarity on the issues involved.

**10.0.2** To achieve a parallel outcome in relation to audit,

**10.0.3** I recommend that the audit committee publish a three-year rolling Audit and Assurance Policy which would be put to an annual advisory vote by shareholders for approval at the Annual General Meeting.

**10.0.4** Such a policy would provide a context for audit committee disclosures referred to above. It would also link to the Resilience Statement, the successor to the Going Concern and Viability Statements (see later in this Report).

**10.0.5** It would, inter alia,

- explain the process of appointing auditors;
- explain the work demanded of the auditors and any conditions attached;
- explain the fees basis for audit work;
- provide a framework for decisions about materiality;
- explain how seeking assurance relates to the Risk Report of the directors;
- indicate how shareholders should interpret the resulting audit reports;
- explain the approach taken to compiling the Resilience Statement and the associated extent of auditor engagement; and
- explain the approach taken to obtaining and reporting on assurance around internal controls, both in relation to the financial reporting and operational controls.

**10.0.6** In doing so ***the Audit and Assurance Policy should encompass assurance beyond that required for the financial statements.*** It is here that the directors will be able to report, for example, on cyber risk and climate change impacts and explain the degree of assurance sought. The rolling nature of this Policy should also make it simple to evidence learning, and



reflect changes in circumstance, from one year to the next. This Policy provides the opportunity for companies to show how they are assuring the integrity of reporting, and handling of risk, whether required to do so by law or not.

**10.0.7** Within this policy, *the assurance budget should be published, divided by broad categories of expenditure planned for the first year of the rolling three-year period covered*. This budget would encompass both external fees, the cost of internal audit and any other forms of assurance that the company chooses to obtain.

**10.0.8** In this way I consider it is possible to respond to those who are keen to have assurance extend to the front end of the annual report by the directors. The Audit and Assurance Policy, in describing the extent of assurance that the directors have selected, should make clear which parts of the front end will be assured. It will then be open to shareholders to challenge this approach. In this way proportionality is maintained in the interest of primary users; cost is not created where shareholders and directors see no value in incurring it, but where either does, then assurance can be extended. This approach also maintains the distinctiveness of the statutory audit of the financial statements as a subset of the wider audit and assurance umbrella.

**10.0.9** Nonetheless, it is argued by some that statutory audit should be extended to a “fuller due diligence style assurance report”<sup>111</sup>. This would encompass:

- the quality and reliability of the company’s financial statements;
- the continued relevance of the organisation’s business model, corporate strategy and its prospects;
- the principal risks facing the organisation and the effectiveness of its risk management and internal control arrangements; and
- the organisation’s culture and ability of the senior management team.”<sup>112</sup>

**10.0.10** In my view there are major drawbacks to such an approach. I am persuaded that whilst auditors may have a wide variety of skills, it is not a requirement of today’s auditors to have formal expertise in assessing business models<sup>113</sup>, corporate strategy, culture, values and principles and management ability.

**10.0.11** There are no obstacles to shareholders, or others, seeking private assurance in any of these areas from suitably qualified auditors. In the model for the audit profession proposed in this Report, shareholders would be able to ask for assurance in any of these areas. The decision whether to respond to such requests positively would remain with the Board, who already have responsibility for these areas and for reporting to shareholders on them.

## 10.1 Fair, balanced and understandable

**10.1.1** The UK Corporate Governance Code requires the directors to state that the annual report, taken as a whole, is “Fair, Balanced and Understandable (“FBU”)”. The auditors are required to report by exception if the directors’ statement is materially inconsistent with their knowledge obtained in the audit. I am not aware of any cases to date where the auditors have said anything of substance publicly regarding the directors’ statement (they invariably state that they have nothing to report).

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<sup>111</sup> Submission by Christopher Burt, Halex Consulting Ltd (10 May 2019)

<sup>112</sup> Burt *ibid*

<sup>113</sup> Although some course work (e.g. in ICAEW qualification as ACA) does touch on business models etc.

**10.1.2** Academic research published by ICAS in 2016<sup>114</sup> indicated that auditors interpret this responsibility differently, both within and between firms, and its impact in practice has been limited. This is consistent with the findings of an FRC thematic review on “Other Information in the Annual Report” published in December 2018. The latter report also stated that “Many users of the Annual Report do not understand ... the work auditors are required to perform on the Other Information... Many incorrectly assume that the Annual Report as a whole has been audited.”

**10.1.3** The Audit and Assurance Policy model I propose would provide the opportunity for the directors to seek specific assurance on their FBU statement or any other unaudited material in the Annual Report. The auditors could then report on both their conclusions and the basis for them. I believe such a model is likely to be much better understood by both auditors themselves and the users of their reports.

## 10.2 Giving employees a voice

**10.2.1** One commentator emphasised the fundamental importance to the workforce of the “sustainability of the business model” and the need for the voice of the workforce to be heard. I consider that employee engagement on this point is capable of being addressed in much the same way as I have recommended shareholders engage with the audit committee. I recommend that:

**10.2.2 A simple mechanism to enable the workforce to raise issues around risks and assurance should be developed in each company, so that the designated director (or other mechanism) be the recipient of those inputs. The company should then have an obligation to respond to the workforce as to the way in which it has reacted to their requests.**

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<sup>114</sup> Ian Fraser and Boram Lee, *Fair, Balanced and Understandable: Enhancing corporate reporting and assurance?*; ICAS (2016)

## 11. True and fair?

**11.1** Accounting has changed from giving an account, with a focus on facts, to the provision of decision useful information. At its heart the adoption of fair-value accounting has introduced hypothetical valuations. This change necessarily impacts auditing and, to a degree, explains the disproportionate emphasis on compliance rather than informing.

**11.2** The world of accounting is replete with arguments about the relevance and meaning of truthfulness; some “refuse to engage in any search for the meaning of ‘truth’ in accounting”<sup>115</sup> whilst others argue that “no scientific method permits anyone to discover or observe absolute accounting ‘truth’.”<sup>116</sup>

**11.3** Since the introduction of IFRS, the financial statements contain many estimates and assumptions (generally required to be set out in the notes to the accounts) that are dependent on judgments about the future<sup>117</sup>. It does not need a philosopher to question how an opinion about judgments relating to the future can be “true”. Other jurisdictions have used different language.

**11.4** It is not within the scope of this Report to make recommendations about the future of accounting standards, despite considerable anxieties being expressed to me, but rather to attempt to improve the quality and effectiveness of audit given the present accounting framework, whether UK GAAP or IFRS. I hope, nonetheless, by drawing attention to the dilemmas associated with the use of “true”, that this Report can help to educate those who read and use audit reports.

**11.5** UK company law requires “true and fair” financial statements to be prepared but both preparers and auditors appear to treat this in practice as being synonymous with compliance with accounting standards. I am also mindful that some consider that a desire to bring clarity has resulted already in extensions of the audit report away from purely consideration of financial statements. For some this has raised expectations and confused the role of the auditor. Others welcome the greater information flow, as do I.

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<sup>115</sup> John McKernan & Patrick O'Donnell, *Cognitive objectivity in accounting*; The 2002 Critical Perspectives on Accounting Conference, Baruch College, New York

<sup>116</sup> Brian Shapiro, *Objectivity, relativism and truth in external financial reporting: What's really at stake in the disputes?*; Accounting, Organisations & Society 22(2) (1997)

<sup>117</sup> “Although the requirement for annual accounts of a company to give a true and fair view was introduced by the amending Companies Act of 1947, the terms “true” and “fair” were not new in the law relating to company accounts. The Joint Stock Companies Act of 1844 required companies to present “a *full and fair* balance sheet”, the Companies Clauses Act of 1845 required the preparation of an “*exact* balance sheet” showing “a *true* statement” of the assets and liabilities, and the Companies Act of 1879 referred to “a *full and fair* balance sheet properly drawn up, so as to exhibit a *true and correct* view of the state of the company's affairs”. Prof David Flint, University of Glasgow, published for the Institute of Chartered Accountants of Scotland (ICAS) by Gee & Co in 1982

**11.6** Flint<sup>118</sup> argues that a true and fair view “has a conceptual quality of great merit. Properly understood and diligently applied in practice, it is well designed to serve the public interest. Not least, it recognises the cultural dependence of accounting and financial reporting, and the fact of its evolving continuously to meet the needs and expectations of the changing social and economic climate.” Notwithstanding this argument and, noting the imperative for there to be proper understanding, I consider that the opinion that the financial statements are “true and fair” in a literal sense undermines the credibility of audit.<sup>119</sup>

**11.7** A further comment from Flint<sup>120</sup> is worthy of consideration. He writes that “the fact that a “true and fair view” is a philosophical concept and not susceptible to definition by a comprehensive set of detailed rules is, in fact, its most fundamental and characteristic feature.” I consider that this overarching supremacy of “truth” can be achieved by means of a set of principles that auditors must embrace rather than the perpetuation of language that confuses.

**11.8** Thus,

**11.9** I recommend that the Companies Act<sup>121</sup> and ISA (UK) 700<sup>122</sup> be amended to replace “true and fair” with “present fairly, in all material respects.”

**11.10** Lest anyone considers this may weaken the force of the opinion, I consider, to the contrary, that its accuracy will strengthen the value of the opinion. It is perhaps worth recalling the words of J.C. Shaw<sup>123</sup> “the audit opinion does not say that the accounts are ‘correct’; it does not imply absolute accuracy; it does not imply that the financial policies and techniques are, in the opinion of the auditors, the only ones, or the ‘best’ ones.”

**11.11** The combination of this proposed refreshed clarity and the establishment of a clear set of behavioural principles should mean that the force of the audit is made stronger not weaker. Furthermore, both IFRS and UK GAAP are “fair presentation frameworks”, i.e. they require preparers to provide further disclosures, or depart from a requirement, if necessary to achieve fair presentation.

**11.12** This requires the auditor to exercise judgment, for which solely relying on compliance with standards is insufficient.

**11.13** One other objection to the recommendation may be that today there exists in company law and IAS 1 the opportunity to use a “true and fair override” in the accounts, but whilst this is so, this override is very rarely used. IAS 1 states that compliance with IFRS achieves a fair presentation “in virtually all circumstances” and indicates that it should be “extremely rare” to need to depart from an IFRS requirement.<sup>124</sup> The UK additions to ISA 700 refer to an FRC legal opinion stating that compliance with relevant accounting standards does not guarantee that a true and fair view/fair presentation is achieved. The overall message is the same as IAS 1 though: only in extremely rare circumstances should it be necessary to depart from a requirement of

<sup>118</sup> Flint *ibid*

<sup>119</sup> I cannot claim originality: Cowan noted more than 50 years ago: “The Oxford English dictionary defines truth (of statements) as ‘consistent with fact; agreeing with reality; representing the thing as it is.’ I suggest that few accounting reports would measure up to these standards today. Instead there is a reliance, not on the fundamental objective of truth, but rather on what is commonly done. If so, it is perhaps time that we ceased to use the word “true” in our legislation and in our audit reports?” Tom Cowan, *Are Truth and Fairness Generally Acceptable?*; *The Accounting Review*, Vol. 40, No. 4, pp. 788-794 (1965)

<sup>120</sup> Flint *ibid*

<sup>121</sup> Section 495(3). There will need to be a corresponding change regarding the responsibilities of directors.

<sup>122</sup> Paragraph 25. This states that these two phrases are regarded as being equivalent.

<sup>123</sup> John Shaw, *The Audit Report: What it says and what it means*; in a monograph for ICAS published by Gee & Co (1980)

<sup>124</sup> This was further confirmed in a meeting with a board member of IASB as the board’s intention at the time.

the applicable accounting framework to achieve a fair presentation<sup>125</sup>. This messaging in the accounting and auditing standards helps to explain why it is now very rare in practice for the “true and fair override” to be used.

**11.14** I am keen that this override provision is not lost. It is a valuable safety valve and draws particularly on the quality of an auditor’s judgment. In order to ensure that there is a strengthening of its role,

**11.15 I recommend that auditors judge their opinion on any use or proposed use by directors of the (now) fairly presented override in the context of their obligation to be faithful to the Principles of Corporate Auditing.**

**11.16** Although very rarely used, “there have been examples where the override has been used under IFRS, both inside and outside the UK.”<sup>126</sup> HSBC and National Express are examples. This infrequency of use seems unlikely to be appropriate given the need to exercise judgment in assessing fair presentation.

**11.17** For those concerned with an expectations gap this would be an important step to aligning the audit output with reasonable expectations.

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<sup>125</sup> ISA (UK) 700, para A16.

<sup>126</sup> Financial Reporting Council, *True and Fair* (June 2014)

## 12. Accounting Records

**12.1** The next section covers internal controls. Before that, it is worth noting that s386 CA06 requires all companies to keep adequate accounting records, while s498 CA06 explains the duty of the auditor in this regard. Auditors' responses to the Call for Views indicated a lack of understanding of what was expected of them regarding accounting records, beyond establishing their adequacy to prepare the financial statements.

**12.2** I note also the following comment in a paper by ICAEW<sup>127</sup>: "It seems possible, at least, that if there were clearer and more detailed guidance relating to accounting records, the preparation of financial statements and the link between the two, some of the misreporting that has given rise to the current Reviews of auditing in the UK might have been avoided."

**12.3** This statement goes to the heart of the issues around quality of audit. Given that auditors already have an obligation to state "whether a company in their opinion has kept adequate accounting records"<sup>128</sup>, it is very disappointing that the accountancy profession has not offered detailed guidance in this area. As far as I am aware there has been and remains nothing to prevent such guidance being given to auditors, although I note that the Companies Act contains some archaic language.

**12.4** I recommend that the Government review the Companies Act to see if it could be improved to give more clarity as to what is meant by "adequate accounting records". Given the complex requirements modern accounting creates, either through law or regulation, there should be an obligation for auditors to assess that the directors have maintained accounting records to a standard beyond the minimum level necessary for an audit to be performed. In doing so, the objective should be a High Quality Audit as defined in this Report.

**12.5** I found it surprising that, in response to my question about how auditors deliver their existing legal obligation in this respect, audit firms did not clearly articulate how they do this, particularly with regard to the need for adequate accounting records to be in place throughout the year and not just at year-end.

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<sup>127</sup> ICAEW, *Internal control effectiveness: who needs to know?*; Future of Audit paper (September 2019)

<sup>128</sup> s498 CA06

**12.6** The ICAEW produced guidance in 2011 (TECH 01/11) on directors' obligations to ensure that there are adequate accounting records. Such guidance seems to fall today firmly in the lap of the accountancy profession, but, as far as auditors are concerned, it would move to the new profession.

**12.7** Therefore,

**12.8 I recommend that ARGA promptly develop guidance for auditors around their responsibilities in relation to accounting records.**

**12.9** If auditors do not think that directors are meeting their obligations, they have all the tools they need today through the audit report to call this out. They should. This is the starting point for discussing internal controls.

## 13. Internal Controls

### 13.1 Introducing a UK version of SOX.

**13.1.1** Sir John Kingman recommended<sup>129</sup> in December 2018 that serious consideration should be given to the case for a strengthened framework around internal controls within UK companies, learning relevant lessons from the United States experience of implementing and operating the 2002 Sarbanes-Oxley Act (SOX). I note that the Government has welcomed this recommendation and BEIS is in the process of formulating proposals.

**13.1.2** As input to that process, I comment here on the potential role of the board and the auditor in such a strengthened framework. In doing so I am mindful of the need for proportionality regarding any incremental costs involved. Evidence from Audit Analytics<sup>130</sup> shows, since the introduction of SOX, a reduction in the number of reissuance statements from accelerated filers in the US, from 460 in 2005 to just 29 in 2017; except for 2005 the percentage of companies exempt from auditor attestation exceeded the percentage of non-exempt companies. I also note that in the United States a report by Protiviti<sup>131</sup> estimates the cost of audit of internal control over financial reporting and associated attestations as approximately one third of audit costs.

**13.1.3** The UK Corporate Governance Code already requires that boards of premium listed entities:

- undertake a robust assessment of the company's emerging and principal risks, and confirm in the annual report that it has completed this assessment, including a description of its principal risks, the procedures in place to identify emerging risks, and an explanation of how these are being managed or mitigated;
- establish procedures to manage risk and oversee the internal control framework; and
- monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness and report on that review in the Annual Report.

**13.1.4** It is widely agreed, as reported by EY<sup>132</sup>, that “the extent and nature of work performed in support of these requirements and reporting obligations varies and usually does not involve detailed testing of the effectiveness of controls.”

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<sup>129</sup> Kingman *ibid*

<sup>130</sup> Audit Analytics, *2017 Financial Restatements*

<sup>131</sup> Protiviti, *Benchmarking SOX costs, hours and controls* (July 2019), <https://www.protiviti.com>

<sup>132</sup> EY, *Protecting Stakeholders, Enhancing internal control accountability in the UK* (August 2019)



**13.1.5** Because of the structure of the unitary board in the UK, the singling out of CEOs and CFOs to make attestations to shareholders (as in the United States) is potentially problematic. Nevertheless, there is sufficient evidence to suggest that such attestations have improved relevant internal controls and may have helped to lower the cost of capital.<sup>133</sup>

**13.1.6** I also note the views of the ACCIF submitted to this Review that there is support for the introduction of a SOX-lite (undefined) regime in the UK.

**13.1.7** There is a distinction to be made between the risks reported under the Code and the risks specific to the construction of the financial statements. Considering the latter, and to accommodate the UK board structure,

**13.1.8** I recommend that the Government gives serious consideration to mandating a UK Internal Controls Statement consisting of a signed attestation by the CEO and CFO to the Board that an evaluation of the effectiveness of the company's internal controls over financial reporting<sup>134</sup> has been completed and whether or not they were effective, as in SOX 302(c) and (d).<sup>135</sup> This attestation should be received by the Board no later than 28 days before the accounts of the company for the relevant financial period are signed. The Board should then report to shareholders that it has received such an attestation.

**13.1.9** Given the considerable cost of extending the remit of the auditor to opine on the attestation, a company which referenced such an attestation would not normally be required to have the attestation audited. However, I suggest that ***a failure of relevant<sup>136</sup> controls in the 12 months prior to the attestation or in the 12 months following should result in a requirement for future statements to be audited for a period of three years following the failure. The directors should state if such a failure has occurred.*** I understand the argument that management may change in this period but I judge the effect of such a sanction is likely to assist in ensuring that attestations are made with the necessary focus. It would, of course, remain open to any board or, on its behalf, audit committee, to choose to have the attestation audited. In this way additional costs of audit will only be borne by those who wish to bear them or who have failed in their recent reporting.

**13.1.10** Shareholders and other stakeholders are relying on the judgment of the company's directors. Should this recommendation be accepted, it would be disappointing were directors then to devise standards to apply across all companies. As has been seen with auditing, such standards drive a compliance mindset which often loses sight of the true purpose of the activity.

**13.1.11** I recommend instead that the ACCIF develops principles that should be followed by CEOs and CFOs in making an internal controls effectiveness attestation. Final endorsement of these principles should be made by ARGAs.

<sup>133</sup> Studies at University of Kentucky and Louisiana Tech in 2014, and at Butler University for the period from January 1996 to December 2006, quoted in EY *ibid*

<sup>134</sup> Based on a UK customised version of the Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organisations of the Treadway Commission in the United States (COSO).

<sup>135</sup> SOX 302: “The signing officers ... [C] have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and [D] have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date”

<sup>136</sup> The definition of “relevant” would need to be developed by ARGAs with reference to materiality, along with a reporting obligation for failures.

**13.1.12** *Where weaknesses (and/or failures) in controls have been reported it should become an obligation on directors to report on what remedial action has been taken and on its effectiveness. Where the same or any other material weakness persists over two reporting periods, boards should be obliged to have their attestations audited until the controls can be pronounced effective.*

**13.1.13** Regarding entity-level controls (beyond those relating to the financial statements), there is some demand for such a regime to embrace them also. Such work would impinge upon the governance of risk management. As noted, boards today are required to monitor the company's risk management and internal control systems and, at least once a year, carry out a review of their effectiveness. ***In reporting on this work boards should make clear what processes have been considered and reasons for their confidence in their effectiveness.*** I consider, however, that it would be a step too far to extend the proposed UK Internal Controls Statement to entity-level controls. Taken together with the recommendation below regarding directors' reporting on controls designed to prevent material fraud, today's regime is likely to offer shareholders the assurance they seek. How each company chooses to do this would form part of their Audit and Assurance Policy. It would always be open to shareholders to ask for more assurance where they consider it warranted.

**13.1.14** It is very noticeable that SOX was developed and became effective within six months of the failure of Enron. This speed of legislation has been criticised and SOX has evolved since; nevertheless, the UK needs to be wary of many years of consultation and discussion and needs to make a decision promptly, but with flexibility to make amendments as real time experience dictates. This desire for seemingly endless discussion of detail has contributed, in part, to the lack of action following the MacFarlane Report of 1992.

## 13.2 Internal Audit

**13.2.1** In respect of the control environment, I welcome the work of the Chartered Institute of Internal Auditors ("CIIA") and their consultation on an Internal Audit Code of Practice<sup>137</sup>. Enhancing the role of the internal audit profession ought to assist audit committees in their work.

**13.2.2** It will be relevant to report on the role of internal audit in the Audit and Assurance Policy and I hope that, encouraged by the adoption of this Code, there will be more transparency around the role and activity of the internal audit function.

**13.2.3** I heard frequently that ISA (UK) 610, which governs how auditors may make appropriate use of internal audit work without receiving direct assistance, is complex to adhere to. As a result, there is very limited use made of internal audit by external auditors. ***I suggest that the standard be reviewed with a view to encouraging greater but still appropriate use of internal audit by the external auditor.***

**13.2.4** Whilst there are limits to the reliance that external auditors may wish to place on the work of internal audit, the external and internal auditors should meet to share all relevant information at the start of setting the audit plan and assessing the environment in which an audit is to take place.

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<sup>137</sup> Institute of Internal Auditors, *Internal Audit Code of Practice; Consultation on the draft code* (July 2019) – due to be published in January 2020

## 14. Fraud

**14.0.1** Of all the topics covered by the Report, I have found the question of fraud and auditors' related responsibilities the most complex and most misunderstood in relation to auditors' duties. "Fraud is a broad legal concept and the auditor does not make legal determinations as to whether or not fraud has occurred. The Companies Act makes no explicit reference to any responsibility of the auditor with respect to fraud. The auditing standard dealing with fraud (ISA (UK) 240) directs auditors to focus on intentional misstatement of the financial statements, arising from either fraudulent financial reporting or mismanagement of assets. It requires auditors to make a rebuttable presumption that revenue may be materially misstated due to fraud and to design and perform appropriate audit procedures in response to this and other identified fraud risks."<sup>138</sup>

**14.0.2** ISA (UK) 240 appears to be a balancing act between managing, or possibly lowering, expectations whilst seeking to avoid going so far as to affect significantly users' perceptions as to the value of audit. The messaging in this standard is therefore somewhat ambiguous, in my view, contributing to a lack of clarity as to what exactly is expected of auditors in this area. Indeed, a number of respondents<sup>139</sup> called for auditors' responsibilities to be clarified, whether or not they believed there is or may be a case for increasing them.

**14.0.3** I note that the US standard<sup>140</sup> is very similar to the ISA and the recent Colonial Bank case in the US<sup>141</sup> highlighted a similar lack of clarity. The case centred on professional negligence claims relating to fraud at the failed bank.

**14.0.4** Some of this ambiguity stems from the introductory section of the standard. As well as stating that directors and management have primary responsibility for preventing and detecting fraud, it stresses that the auditor is less likely to detect a material misstatement due to fraud as a result of sophisticated efforts to conceal fraud. It also stresses that there is a higher risk of not detecting management fraud because of their ability to override controls and directly or indirectly manipulate accounting records.

**14.0.5** It is consequently understandable that there is both confusion and a gap between the reality and the expectations of performance of auditors in this area. If an auditor is giving an unmodified opinion, then he or she is stating effectively that they have obtained a "high level" of assurance that the financial statements are "true and fair" or "presented fairly in all material respects". But some would ask: how can this be so, if there has been a material fraud that

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<sup>138</sup> This Review, Call for Views (April 2019)

<sup>139</sup> E.g. "Even the current standards could be construed as placing a responsibility on the auditor for detecting material fraud" submission by Duncan & Toplis (21 May 2019) and "If the auditors are not looking for fraud, that dramatically reduces the value of the audit" submission by Sarasin & Partners (14 June 2019)

<sup>140</sup> AS 2401 *Consideration of Fraud in a Financial Statement Audit*

<sup>141</sup> The Federal Deposit Insurance Corporation announced a substantial settlement with the relevant auditor in March 2019.

the auditor has failed to detect? Relying on users fully understanding that auditors may have done enough work to reach a reasonable expectation of the financial statements being free of material misstatement is not a satisfactory answer.

**14.0.6** Yet, Harry Goddard of Deloitte<sup>142</sup> said recently “statutory auditors, working essentially to a 175-year-old model and a set of responsibilities laid down in law, are not fraud investigators.”

## 14.1 Clarity of auditor obligations

**14.1.1** PwC’s Future of Audit report refers to “a clear demand from investors for greater detail about the risks of fraud, with a substantial majority of investors in favour of expanding the scope of the audit to including detecting fraud”<sup>143</sup>. The report also refers to the scope for auditors to harness new technologies to enable them to identify potentially fraudulent activities, noting “widespread optimism” as to the impact that this could have (including, presumably, from a cost-benefit perspective).

**14.1.2** There are essentially two broad types of fraud: one which involves inappropriate movement of physical assets or cash in some form and the other where there is deliberate misrepresentation of the underlying financial or other relevant information of the company. In both instances there is likely to have been a failure of controls enabling this perpetration by a lone individual or through collusion with other individuals, either inside or outside the company, or both.

**14.1.3** Material fraud is most likely to be the result of collusion to bypass standard authorisation controls. It may also involve an abuse of the auditor’s materiality threshold, allowing perpetrators to circumvent standard testing by ensuring that fraudulent transactions are below that threshold. Auditors will review large and unusual movements in cash and balances, but a determined fraudster will know how to get below the materiality threshold so as not to raise a red flag to the auditors.

**14.1.4** In order to dispel the current confusion,

**14.1.5 I recommend that ARGA amends ISA (UK) 240 to make clear that it is the obligation of an auditor to endeavour to detect material fraud in all reasonable ways.**

**14.1.6** I note that this will be consistent with the views of the Chair of the FRC, expressed in November 2019.<sup>144</sup>

<sup>142</sup> Interview with Harry Goddard, Deloitte Ireland, The Independent (10 October 2019)

<sup>143</sup> PwC, *Future of Audit*, *ibid*

<sup>144</sup> Financial Times, *FRC chairman calls for break-up of Big Four accountants* (7 November 2019)

## 14.2 Directors' obligations

**14.2.1** It is clear that “the extent to which fraud can be detected is dependent on the quality and timeliness of management reporting, and the openness of the corporate culture”<sup>145</sup>, and the first part of the Standard on Fraud<sup>146</sup> stresses that management and the Board are responsible for preventing and detecting fraud.

**14.2.2** I recommend therefore that directors should report on the actions they have taken to fulfil their obligations to prevent and detect material fraud against the background of their fraud risk assessment.

**14.2.3** Fraud is a challenge faced in corporate reporting worldwide. SK Lokeshwarri comments in the Hindu Business Line<sup>147</sup> in September 2019, regarding what is known as the Satyam case, that the Securities and Appellate Tribunal's (“SAT”) ruling in India means that “where the company’s management intentionally falsifies accounting statement [sic], auditors need not worry if they have conducted their work in accordance with auditing standards. Only if they have connived in falsifying the financial statements of a listed company, will SEBI<sup>148</sup> get the power to pass a preventative and remedial order, restraining them from future audits of limited companies.” ... “SAT has pointed out that the auditor is required to employ reasonable skill and care but the auditor is not required to begin with suspicion or to proceed in the manner of trying to detect fraud or a lie, unless some information has reached [the auditor] which creates suspicion.” This ruling supports the concept of the auditor as watchdog rather than bloodhound, one which was first referenced in the 19th century. However, “reasonable skill and care” leaves much room for misunderstanding.

## 14.3 Forensic skills

**14.3.1** I disagree with the conclusion laid out above. It is instructive to consider what happens when a deep suspicion of fraud emerges. Generally forensic accountants are brought in to examine in much greater depth the area concerned. Auditors, however, start with a neutral mindset – assuming neither honesty nor dishonesty with respect to the preparation of the information provided and seek confirmation of its appropriateness. This aspect of seeking confirmation will be referred to in the next section regarding the “fit” of the auditor.

**14.3.2** If there is to be a reconciliation between this reality and the widespread expectations about what is sought from the auditor, auditors need to learn to be able to apply the same mindset as do forensic accountants in relevant circumstances. I have commented earlier on the need for an auditing profession. In developing the syllabus for the education of auditors, leading to a qualification to practice,

**14.3.3** I recommend that training in both forensic accounting and fraud awareness be parts of the formal qualification and continuous learning process to practice as a financial statements auditor. In developing qualifications for auditors of other areas of activity, parallel training should be established.

<sup>145</sup> Tim Ward *ibid*

<sup>146</sup> ISA (UK) 240

<sup>147</sup> SK Lokeshwarri, *Auditors' duty is to verify, not detect*; The Hindu Business Line (11 September 2019)

<sup>148</sup> Securities and Exchange Board of India

**14.3.4** Auditors need to communicate what procedures they have undertaken to enable their opinion about the financial statements to be appropriate with regard to the risk of fraud. If the consequence is greater narrative (not in boiler-plate form) and a clearer statement of the reliance users may place on this work, then I consider that this would be an advantage. Consequently,

**14.3.5** I recommend that the auditor's report state explicitly the work performed to conclude whether the directors' statement regarding the actions they have taken to prevent and detect material fraud is appropriate. Furthermore, the auditors should state what steps they have taken to assess the effectiveness of the relevant controls and to detect any such fraud.

**14.3.6** This might include, for example, stating any material frauds of which the auditor has experience in companies in the same industry and what tests it applied to address the risk of a similar fraud having occurred.

## 14.4 Fraud Register

**14.4.1** There are many aspects of society where certainty is simply not possible to achieve, however much many would wish otherwise. This is one such. However, I believe with sharper training (of humans and algorithms), greater disclosure and more focus, both by directors and auditors, significant improvement in detection and understanding of material fraud should be possible. One final step which I consider would help would be for **ARGA to stimulate the production of a publication which would set out a British version of the AICPA's fraud certification parameters for different industries**<sup>149</sup>.

**14.4.2** ARGA can help in other ways too.

**14.4.3** I recommend that ARGA maintains an open access case study register detailing corporate frauds that have occurred in order that auditors can learn in real time from these frauds.

**14.4.4** Auditors would be obliged to file a case study (suitably anonymised) of each material fraud discovered to keep this register up to date.

## 14.5 Post Fraud Judgments

**14.5.1** There is a deep anxiety that, as the role of the auditor explicitly involves increased focus on fraud detection, failure to find fraud is judged in hindsight in a prejudiced manner. It is all too easy to see the unravelling of collusion laying bare what with hindsight is obvious, but in real time was not.

**14.5.2** In judging the potential culpability of the auditor in failing to detect a fraud, there needs to be a framework that is trusted as impartial and reasonable. A suspicion that a regulator may have an interest in scalp-hunting is not helpful – confidence is essential. I consider that the successful experience of the Panel on Takeovers and Mergers (“The Panel”) provides a template for how such confidence could be established. The Panel, chaired by an eminent lawyer, and consisting of senior and experienced practitioners drawn from investors, advisors, corporates

<sup>149</sup> <https://www.aicpa.org/press/pressreleases/2018/aicpa-announces-new-professional-certificates-in-forensic-accounting.html>

and others, has achieved this confidence in its conclusions in complex cases. Furthermore, it has established such trust that the courts will very rarely take a case following an adjudication of the Panel.

**14.5.3** With a view to achieving the same status,

**14.5.4** I recommend that ARGA establish an independent Auditor Fraud Panel<sup>150</sup> to which it would refer the results of any investigations into auditor failure to detect material frauds and that such a Panel should be equipped with the ability to levy sanctions on auditors as appropriate.

**14.5.5** I consider such a Panel would give auditors confidence in the process of adjudication to which they would be subject and lessen the risk of court proceedings.

## 14.6 A Fraud Package

**14.6.1** I have laid out here a package of measures – the combination of clarity about roles, enhanced education, greater disclosure of anti-fraud measures taken, a fraud register and an independent sanctions regime – which taken together will, I consider, go a long way to restoring confidence in auditors in this area.

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<sup>150</sup> This would be entirely different to the existing Fraud Advisory Panel – <https://www.fraudadvisorypanel.org/>

## 15. A question of fit

**15.1** I have found significant confusion about the role of audit, particularly amongst company management. I found frequently, in my Review consultation, members of management who articulated very clearly what they wanted from the auditor and it was frequently about “helping us to improve our processes”<sup>151</sup> and “to help me trace the cash”<sup>152</sup>. It is highly desirable that processes are made better and cash can be traced, but these are the jobs of the management not the auditor.

**15.2** If audit is defined as focused on enhancing trust and engendering confidence, then whilst it might be an interesting and valuable by-product of an audit that it helps to “upskill the finance function” through “sharing the audit team’s knowledge”<sup>153</sup>, it is not its purpose.

**15.3** I have heard it said by front-line auditors that their objective is to achieve a clean audit and I believe it is common ground that no public interest would be served by having modified audit opinions presented when management would have been quite willing to have made changes to their presentation of the financial statements that would have avoided the modification. It seems to me that it is reasonable for auditors to assist fully in the process of encouraging such changes. There is, however, a danger here that, in giving such advice, the auditors will end up supplying a form of auditor-consultancy (as distinct from the other consultancy services offered by accounting firms) as a bundled part of the audit and, as a result, end up “marking their own homework”. It will be essential if the good outcomes are not to be lost from this process that audit committees are fully aware of the detail of any advice given in this process. It would then be for the audit committee to determine that no inappropriate crossing of boundaries has occurred.

**15.4** The BEIS Select Committee was particularly concerned about evidence it received about the importance of “cultural fit” in selecting an auditor.<sup>154</sup> Those seeking that “fit” appeared to be management and the auditor rather than, in the first instance, audit committees through their chairs. Apart from the obvious human desire to cooperate and work alongside people with whom there is empathy, I believe this desire for “fit” comes, on the management side, from the desire to obtain help from the audit as described above.

**15.5** It is natural to assume a small alignment of interests between management and auditor in certain circumstances. Management wish to obtain an unmodified audit opinion, are prepared to make amendments to reflect comments from the auditor and produce an annual report

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<sup>151</sup> CFO, FTSE-100 company

<sup>152</sup> CEO, FTSE-100 company

<sup>153</sup> Submission by Qinetiq (30 May 2019)

<sup>154</sup> BEIS Select Committee, *The Future of Audit* (April 2019) Paras 33, 154, 159 and 161.



which meets with the approval of users. The auditor wishes to create an environment in which the causes of errors and adjustments in one year are not perpetuated into a subsequent year of their engagement, thereby creating more work (and risk) for the auditor. Working well, this alignment makes for a good outcome.

**15.6** *If the auditor, at all times, adheres to the Principles of Corporate Auditing discussed above, in particular those relating to impartiality, independence of judgment and avoiding conflicts, then this alignment of interests need not be problematic.* In fact, the quality of the system as a whole may struggle to improve without it. From the auditor's perspective good "fit" probably makes the process of audit easier and the quality of the outcome better.

**15.7** In this context the risk of confirmation bias grows as the fit becomes more comfortable. As noted above in relation to fraud, such unconscious bias can be reduced by, among other actions, introducing a forensic accounting mindset.

## 16. Signalling Concern

**16.1** Just as shareholders will be invited to indicate any anxieties ahead of the scope of the audit being determined by the audit committee, so ***it should be formally incumbent on the auditors to consider any external factors (as well as internal factors) which might signal the need for related work.***

**16.2** Many commentators have noted that there are advance signals when companies are getting into trouble. “But the warning signs are regularly there, in the form of accounting shenanigans or other clear signs that a business is changing direction for the worse, or that excellent results are being reported only because of one-off and non-recurring items.”<sup>155</sup>

**16.3** These issues should already be picked up in the audit but to demonstrate that relevant external signals have been recognised,

**16.4** I recommend that there should be an obligation on the auditors to report to both the audit committee and the shareholders on the extent to which their work has been influenced and informed (or not) by any external signals which might imply enhanced risk in the company whose financial statements are being audited.

**16.5** In particular, they should demonstrate the reason why the relevant signals, if any, did not impact the work undertaken. I have little doubt that good auditors effectively consider such signals already, but I consider, by making the work more explicit, users will gain a greater understanding of the risks and the value of the audit.

**16.6** At the same time the ***directors should report on their reaction to those signals and the auditors should refer to the extent to which they have accepted or tested the directors’ conclusions.***

**16.7** I recommend that ARGA should develop a menu of possible signals and the auditors should report against the relevant parts of that menu.

**16.8** The signals might include, for example,

- extent of short positions;
- negative analyst report on viability;

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<sup>155</sup> Tim Steer, *The Signs Were There*; Profile Books (2018)

- significant and rapid fall in the share price;
- major changes in the share register;
- widening swaps spreads;
- directors selling shares;
- sustained negative commentary;
- loss of banking facilities;
- deteriorating trade credit terms;
- falling credit rating;
- covenant breaches;
- not paying creditors on time;
- z-scores;
- extended late payments;
- late filings; and
- disputes with pension fund trustees.

**16.9** This development would include specific indicators for specific industries: thus, a rapid increase in loan losses may be one such indicator in banking. There will be many others. It would not, however, be acceptable for auditors simply to reproduce a long list of factors purporting to be the base for their work; this would not be consistent with the Principles of Corporate Auditing.

**16.10** The auditors should also reference the Prudential Regulation Authority (PRA) risk assessment reports of the general background to trading, not only for financial services companies.

## 17. Communicating judgments

**17.0.1** HSBC Global Research<sup>156</sup>, in commenting on future developments in audit, said “we think a key component to improve the effectiveness of audits is better communication with investors.” Here I consider what should be communicated if the objectives of this Report are to be met.

**17.0.2** Many items that contribute to the financial statements, for instance, are the result of judgments as to appropriate values. IFRS requires disclosure of the reasons for having chosen a particular treatment of a value, but this does not, in my view, give sufficient information as to the range of options. ***Whether there has been disagreement with management or the audit committee or not during the course of the audit, auditors should be required to identify the relevant variables to the audit committee and the resolutions made.*** Such identification should be subject to an explicit and agreed materiality test.

**17.0.3** Where the audit committee has been presented with evidence of differing views between management and auditors over the value or construction of particular items,

**17.0.4** I recommend that the audit committee should describe the content of the debate and its outcome, including the justification for the agreed treatment. For example, where differences of view would have led to material changes in valuation, even when these differences have been resolved, the audit committee should report on the range of the initial views and where in that range the agreed valuation lies.

**17.0.5** That such differences exist should not be seen as a negative signal, but rather a sign of a culture where the identification and resolution of differences or concerns between management, audit committee and auditor is the norm and is therefore the sign of a healthy and well-functioning audit.

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<sup>156</sup> HSBC Global Research, *Audits analysed. Regulation, reform and revelations*. (Aug 2019)

## 17.1 CGUs and Goodwill

**17.1.1** One particularly difficult area relates to the concept of Cash Generating Units (“CGUs”), where different definitions of the perimeter will lead to very different conclusions about the carrying value of goodwill, as would, for example, the use of different discount rates. There are other reasons why there could be different valuations of goodwill or other intangibles, such as different estimates of future revenue streams.

**17.1.2** I recommend that the consequences of potential differences in treatment of goodwill and intangibles considered by management and the auditor should also be made transparent.<sup>157</sup>

**17.1.3** I recognise that there is a risk that such an obligation may lead to management and auditors being less transparent to audit committees about any initial difference of views. However, company law already makes extensive use of the concept of sanctions against individuals for making “misleading, false or deceptive” statements or providing “misleading, false or deceptive” information to another party, including the auditor. The phrase appears in no fewer than a dozen sections of the Companies Act. I see no reason why this well-established principle should not apply to an attestation by management to audit committees referencing any initial differences of view with the auditor.

**17.1.4** Indeed, the Principles of Corporate Auditing reinforce the obligation on the auditor to report, thus encouraging transparency about initial differences, even when resolved.

## 17.2 Culture

**17.2.1** Another aspect of communication of decision useful information relates to the culture of the company being audited.

**17.2.2** With the greater emphasis on board responsibility for culture,<sup>158</sup> techniques may be developed that will make reporting on culture more amenable to precise examination, with specialist auditors of culture reporting against newly minted metrics. In the absence of such techniques the Principles of Corporate Auditing would demand that if, in the course of an audit, the auditor observes a culture quite different to that described by the directors, whether in the Annual Report or elsewhere, the auditor should make reference to the difference in its report to the shareholders. This would be a proportionate action.

**17.2.3** This particular example illustrates particularly well how auditors should move away from being trapped into reporting only against standards by using their own professional judgment as to the materiality of what they observe. Professional auditors should not need a framework to help them make such an assessment. Rather, they should be willing and able to exercise their professional judgment and express their clear conclusions. Those unwilling to do this will remain victims of today’s negative perception.

**17.2.4** It is important to be clear. Today’s financial statement auditors cannot be expected to give a positive assurance around the company’s culture – this is beyond their skills and remit – but an obligation to call out such inconsistent behaviour would go a long way to alerting shareholders of potential risks in the business, enabling them to exercise their responsibilities better, and make for a more effective audit report.

<sup>157</sup> I note that the IASB is planning to produce a discussion paper in early 2020 regarding whether the assessment of goodwill for possible impairment can be strengthened.

<sup>158</sup> Financial Reporting Council, *Corporate Culture and the Role of Boards* (July 2016)

**17.2.5** For example, where there is evidence of atypical revenue being booked in the last day of a reporting period it is not improbable that therein lies a clue to a pressurised culture where “making the numbers” may trump appropriate behaviour. Consequently,

**17.2.6** I recommend that ARGA develop a series of examples which would illustrate, non-exclusively, the types of culture that auditors should reference in their report where there is an observed disconnect between the culture of the company claimed by the directors and the behaviour observed by the auditors.

## 17.3 Consistency

**17.3.1** There is a widespread desire for consistency from one audit report to the next for any particular company. In order that there are seen to be improvements from one year to the next and to satisfy the desire for consistency, ***it would be helpful if auditors referred back to the prior year’s audit report.*** Knowing this would happen would help to encourage management to address any areas where deficiencies had been highlighted.

**17.3.2** So, where a matter has been identified as a Key Audit Matter or a deficiency in one Audit Report

**17.3.3** I recommend that the auditor explain in each of the two succeeding audit reports what procedures have been undertaken and what conclusions reached in relation to those matters; the auditor should also highlight what actions have been taken by the company in response to deficiencies identified in the prior year’s audit.

**17.3.4** This would give a trail that would show how the company had responded to previous auditor comments. It would also be helpful if auditors were encouraged to give comparisons of the audit scope and materiality thresholds with those of the prior year.

## 17.4 Quality of Estimates

**17.4.1** Accounting is not a precise science. Most numbers in a company’s financial statements require judgment and the use of estimates. For example, even assets that are reported in the books at an historic cost are subject to regular assessment as to whether they need to be written down to a lower value because they can no longer be estimated as being worth that historic cost. More complex assets, particularly those included in the accounts at current valuations (usually referred to as ‘fair values’), are subject to higher levels of estimation and judgment.

**17.4.2** The existence of this imprecision is one reason why auditors have an important role. Most disagreements in accounting are not born of malevolence (or reflect fraudulent behaviour), but rather the use of the scope for judgment and estimation to set out a rosier picture of the company’s position and performance than may be independently judged. The auditor must use his or her own professional judgment to challenge management’s judgments and estimates. This underlies the need for a clear sense of professionalism and principles.

**17.4.3** Many observers believe that there are now more estimates and judgments in accounting than ever before. In part at least, this reflects a greater complexity in modern business: for example, companies use derivatives and other tools to manage their risk exposures, and many businesses have substantial defined benefit pension schemes, in some cases with funding deficits as large as the balance sheets of the companies themselves.

**17.4.4** The lack of precision in valuation has led some to suggest that accounting standards should not require the inclusion of specific point estimates for values. A specific proposal – Confidence Accounting – was set out in a 2012 joint paper.<sup>159</sup> Rather than disclose point estimates for assets or profits, Confidence Accounting would require the disclosure of relevant characteristics of the distribution of possible values. The auditor’s role would be to assess whether the ranges and distribution measures chosen reflected its own understanding of the probabilities embedded in the company’s performance and balance sheet. “‘Balancing the odds’ might well give a truer and fairer picture of accounting than traditional ways of ‘balancing the books’”, the paper argued.

**17.4.5** The ideas underlying Confidence Accounting date back to at least 1977 and there does not seem to have been any take up of the proposals offered by that 2012 paper.

**17.4.6** To address this issue, at least in part, ***the auditor’s report should include some substantive discussion of the key areas of measurement uncertainty and provide information on the ranges and sensitivities associated with the point estimates for those measurements.*** This should be a main objective of the Key Audit Matters within the auditor’s report.

## 17.5 Graduated Findings

**17.5.1** As noted, it has been commented that the market for PIE audit services is one where competition largely occurs in terms of personality and price. I believe that, under recent pressure, new signs of competition in product are also beginning to emerge. The development by one firm,<sup>160</sup> in particular, of a form of graduated findings has attracted some new adherents although its acceptance has been slow to gather momentum.<sup>161</sup> Graduated findings indicate whether individual management estimates are considered to be conservative, balanced or aggressive.

**17.5.2** This evolution is a welcome development and is evidence both of increasing engagement with audit and some signs of functioning competition.

**17.5.3** It is necessary to draw a distinction between a graduated opinion and graduated findings. There is a clear view amongst users of accounts that a single opinion remains of great value and there is no appetite to create a hierarchy of opinions which most see as diluting the importance of that clear opinion. There is, however, a growing appetite for graduated findings. The latter fit into the widespread desire for more narrative accompanying the opinion and for audit reports to be more informative. This is consistent with the conclusions of the 1992 MacFarlane Report.

**17.5.4** For completeness, I should acknowledge a minority view that “the audit framework recognises one level of assurance and therefore risks giving false assurance. Most users are not capable of differentiating ‘different levels’ of assurance, they equate audit with ‘correctness’.”<sup>162</sup> Client Earth add that the “current practice of allowing for different levels of assurance (reasonable, limited, derivative) over different parts of the annual report is very confusing and potentially misleading for users.”<sup>163</sup>

<sup>159</sup> ACCA, CISI and Long Finance, *Confidence Accounting: A Proposal* (July 2012)

<sup>160</sup> KPMG for Rolls Royce plc for the year ended 31 December 2013

<sup>161</sup> Those adopting graduated findings include (as of August 2019) Serco Group, KAZ Minerals, Saga, IP Group, Polar Capital Technology Trust, Quilter, Scottish Mortgage Investment Trust, GVC Holdings and Computacenter

<sup>162</sup> Submission by BDO (7 June 2019)

<sup>163</sup> Submission by Client Earth (7 Jun 2019)

**17.5.5** BDO also point out, as one of the benefits of a binary opinion, that agreements such as banking covenants often directly refer to the need for an unmodified audit opinion. Others insist that a binary opinion forcefully challenges the company, for if an auditor could easily give a lesser degree of assurance, there is a real risk that, to maintain relationships, that will become more frequent in use and less informative.

**17.5.6** I support a binary opinion.

**17.5.7** I have heard the argument that graduated findings need a framework to provide comparability, but I disagree. An increase in the freer form nature of such findings is likely to lead to informing users better and less likelihood that auditors will retreat behind a new form of boilerplate reporting. Again, the Principles of Corporate Auditing, not more standards and rules, should inform behaviour.

**17.5.8** Choice of product is good for the market; individual boards can reflect their choices in their Audit and Assurance policy. Therefore,

**17.5.9 I recommend that the evolution of graduated findings be left to the marketplace for audit services.**

## 17.6 Preliminary Results

**17.6.1** In the Call for Views, I highlighted preliminary results as one area of corporate reporting that is currently not subject to a formal audit. Through responses to the Call for Views, and subsequently, I have received some calls for the full audit of preliminary results announcements, but the weight of the responses, including the evidence of the survey of investors that I commissioned, was not supportive of this suggestion.

**17.6.2** I believe that, in part at least, this is because of the strength of the UK Listing Rules regime in this regard. Listing Rule 9.7A.1(2) requires that “the [preliminary] statement must be agreed with the company’s auditors prior to publication” and (4) says “the statement must give details of the nature of any likely modification or emphasis-of-matter paragraph that may be contained in the auditor’s report required to be included with the annual financial report”. This provides important protections whereby the audit must be substantively complete before the results can be announced and there should be no surprising differences between the preliminary announcement and what is disclosed in the annual report.

**17.6.3** This should avoid unhappy situations such as that which occurred this summer at Switzerland’s LumX<sup>164</sup> where the market was surprised when the audited accounts revealed an adverse opinion from the auditor, suggesting a very different financial position from that asserted in the company’s preliminary results statement. Given there is academic evidence<sup>165</sup> that, unsurprisingly, auditors feel under greater pressure not to raise concerns if the numbers have already been released prior to the completion of the audit, it is important that most difficult discussions happen before the results are announced.

**17.6.4** In order for the UK model to continue to work, ***the auditor must be robust before agreeing to management’s proposed preliminary results announcement.*** If more time is needed before the auditor can agree the numbers, then this time should be taken. The market

<sup>164</sup> “LumX at odds with its auditor over accounting practices”, Financial Times (1 June 2019)

<sup>165</sup> Lori Shefchik Bhaskar, Patrick Hopkins and Joseph Schroeder, *An Investigation of Auditors’ Judgments when Companies Release Earnings before Audit Completion*; Journal of Accounting Research, Volume 57, Issue 2 (May 2019)



should be mature enough to cope with the more frequent delays to results being announced that this may require. Furthermore, ARGAs should be conscious of the negative pressures that may arise from companies seeking to accelerate their financial reporting deadlines.

## 18. Resilience

**18.0.1** Arguably, the information stakeholders most want is reassurance about the resilience of a company. At present they receive this through the mechanisms of the Going Concern and, for premium listed companies, the Viability Statements. Directors have a number of obligations when assessing going concern and the viability of the company. In order to fulfil these obligations, there needs to be greater clarity about the context within which judgments are being made. Sharing information about that context and the actions taken by the directors would assist stakeholders' understanding of these judgments.

**18.0.2** In the course of the Review I encountered frequently a view that accounts, and therefore audits, are backward looking. It may help anyone with this view to enumerate here some of those areas where values are dependent on forward looking assumptions and estimates in the financial statements. These include:

- Mineral resources;
- Investment properties;
- Goodwill and other intangibles;
- Asset retirement obligations;
- Financial instruments and financial disclosures relating to credit losses;
- Pension liabilities;
- Contracts in force.

**18.0.3** In essence, it can be argued that there are no correct values as these all depend on informed estimates about the future of one kind or another.

**18.0.4** Regarding going concern and longer-term viability reporting, most respondents to the Call for Views thought that there was ample room to improve the current requirements. It was argued that the current going concern assessment sets the bar too high for directors having to disclose any 'material uncertainties' relating to a company's ability to continue as a going concern, by allowing proposed mitigating action to be taken into account, and that strengthening related requirements for auditors will not address this underlying weakness.

**18.0.5** The current viability statement was seen by most as not meeting the purpose which informed its introduction to the UK Corporate Governance Code. Those critics saw it as being not so much a serious analysis of a company's future viability, but instead a piece of boilerplate, supported by high level budget and cash flow forecasts over a, typically, three-year period. This was, of course, the view reached by Sir John Kingman also.

**18.0.6** There is also demand for more information about the likely survival of the company into an indeterminate future. This is a legitimate demand informing capital allocation decisions. Whilst independent analysis may provide such information, often privately, not all those with a legitimate interest in this information are sufficiently informed.

## 18.1 A resilience statement

**18.1.1** The future can be broken down into different time periods about which the directors should be able to make statements with varying degrees of confidence: the short term (up to two years), the medium term (from the end of the short term to five years) and the long term (beyond five years), an indeterminate period. It would better inform users of financial statements if these three time periods were brought together in a coherent view of the future, linked firmly to the directors' Risk Report. To achieve this,

**18.1.2 I recommend the board should make a Resilience Statement that incorporates, enhances and builds on the Going Concern and Viability Statements.**

**18.1.3** This Resilience Statement would be broken into three sections:

### 18.1.3.1 Short term resilience

In the first, the time horizon would be set at one year (or such longer period that the directors feel appropriate) and directors would be obliged to state whether in their opinion the company has access to necessary finance to ensure that the company can survive for this period, whilst disclosing any material uncertainties by reference to the Risk Report, and, importantly, before any relevant mitigating action. This statement would be subject to audit in the same way that today's going concern statement is and would form the basis on which the accounts are prepared.

### 18.1.3.2 Medium term resilience

The second part of the Resilience Statement would consist of a statement by directors that they have tested the company's probability of survival in relation to declared future scenarios and expressed their assessment of the resilience of the company in the light of that testing. Directors may wish to use the scenarios currently published by the PRA to stress test their business models or say what other scenarios they have considered. They may also choose to obtain some independent assurance that this work has been undertaken in an appropriate manner. Such assurance would not consider the conclusions which would remain a matter entirely for the directors. The extent of this work, including the extent to which independent assurance has been obtained, would be consistent with the Audit and Assurance Policy presented to shareholders by the directors.

### 18.1.3.3 Long term resilience

Finally, there would be a statement from the directors about the long term resilience of the business. Here the directors would reference the sorts of threats that the company may face – climate change may provide a particularly good example – and describe either why they believe the company is resilient in the face of such threats<sup>166</sup> or what processes are in place to enable

<sup>166</sup> A relevant example would be the company's response to the conclusions of the Task Force on Climate-related Financial Disclosures. It is noteworthy that their 2019 Status Report (June 2019) makes no comment on the need for assurance over disclosures.

the company to plan its reaction to these threats. This part of the statement would not be required to be subject to further assurance, although directors would be free to outline in their Audit and Assurance Policy any supporting work they had commissioned.

**18.1.4** The entire Resilience Statement would have a demonstrable link to the Risk Report.

**18.1.5** I also recommend that ARGA requires auditors to report to the Board of Directors if they have encountered any information in the course of their audit which leads to an anxiety about the resilience of the business not reflected in the Resilience Statement. If they consider the Board does not pay sufficient attention to their anxieties, they should have an obligation to report to ARGA, or an alternative regulator depending on the circumstances.<sup>167</sup>

**18.1.6** For clarity, the absence of such a report by the auditor may not be taken to imply an endorsement of the business model in any way.

**18.1.7** Furthermore, ARGA or other relevant regulators should be given powers to ask for a long form report from auditors when they judge that boards are paying insufficient attention to risks.<sup>168</sup> This recommendation dovetails with the views on a duty of alert expressed in Sir John Kingman's report.

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<sup>167</sup> ISA (UK) 250 section B covers the auditor's existing statutory duty to report to regulators of PIEs and financial sector entities.

<sup>168</sup> I note that in their submission Client Earth observe that some principal risks are not being referenced properly, citing an airline and climate change.

## 19. Capital Maintenance

**19.1** In the course of the Review consultations, I received strong arguments<sup>169</sup> that the Companies Act requirement that dividends must be paid only out of distributable reserves is not being fully respected.

**19.2** The issue – that some dividends may be being paid out of non-distributable reserves – arises from there being no requirement for financial statements to distinguish between the realised and unrealised elements of profit or capital. Furthermore, there are said to be flaws in the complex guidance<sup>170</sup> given by ICAEW and ICAS to auditors. There has been significant work in this area carried out on behalf of 12 organisations<sup>171</sup>. I do not intend to repeat that work here.

**19.3** I am also aware that, in response to both the BEIS Select Committee recommendations on capital maintenance and the earlier government Insolvency and Corporate Governance Consultation, BEIS is further considering this issue.

**19.4** There needs to be a resolution of this issue that assists in ensuring the law is being obeyed without at the same time creating a disproportionate cost for business.

**19.5** Many companies will have grown by acquisition and the historic records of the acquired companies may be insufficient to ensure accuracy. Nonetheless, for many companies, distributable reserves will significantly exceed dividend payments and, given the considerable difficulty and cost involved in determining these reserves precisely, I do not consider it would be proportionate to demand that a full historical analysis be undertaken to provide precision to a number which does not threaten the dividend distribution.

**19.6** Disclosure of distributable reserves is also a problem of a snapshot in time, as companies can and do create distributable reserves by upstreaming cash prior to authorising payment of a dividend.

**19.7** *At the same time, if companies are not to be subject to an obligation to publish historically determined distributable reserves, I recommend that the directors, in proposing a dividend, would need to make a statement that the payment of this dividend in no way threatens the existence of the company in the ensuing, say, two years in the light of the risk analysis undertaken. The directors should also confirm that this*

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<sup>169</sup> Inter alia from Natasha Landell-Mills and Baroness Bowles

<sup>170</sup> TECH 02/17BL, *Guidance on Realised and Distributable Profits under the Companies Act 2006*

<sup>171</sup> Brunel Pension Partnership Ltd, Castlefield Investment Partners LLP, Columbia Threadneedle Investments (EMEA), GO Investment Partners LLP, Hermes Investment Management, Legal & General Investment Management, Local Authority Pension Fund Forum, Local Pensions Partnership, Sarasin & Partners, SCM Direct, SVM Asset Management Ltd, UK Shareholders' Association

**statement is consistent with the Resilience Statement, has been assured in accordance with the Audit and Assurance Policy and that this dividend is within known distributable reserves.** This known amount may not be the complete amount.

**19.8** By contrast, **for a company where it is likely that distributable reserves are deemed “similar” in size to a proposed dividend, that dividend can only be recommended by the directors if the level of the distributable reserves is established and payment of that dividend is consistent with obligations of the directors under the Companies Act and consistent with the Resilience Statement. These distributable reserves would be subject to audit.** “Similar” would need to be unambiguously defined across all companies following an appropriate consultation by ARGA.

**19.9** For all companies the contribution to (or deduction from) distributable reserves in any year following the adoption of these proposals would be required to be published in the financial statements for that year. In doing so directors would be required to have proper regard to their obligation to take into account foreseeable losses calculated in line with s840 CA06. This is a different basis from a calculation under IFRS. It would then fall to the directors to explain any difference arising. Clarity will need to be given between individual company balance sheets and P&Ls and consolidated group numbers.

**19.10** Additionally, the notes to the financial statements should include a statement from directors about any substantial obstacles to paying dividends up to the parent company, and the amounts involved, within a group.

**19.11** There have been demands that auditors opine on the legality of a particular dividend but I consider that it is beyond their competence to make legal pronouncements. By adopting the proposals here, the auditor would not be sucked into the problematic area of determining legality but rather be able to focus on the accounting facts of the case. Furthermore, such a step would not affect the use of IFRS in the financial statements.

**19.12** I note that the Investment Association has recommended the development of a Distribution Policy by boards<sup>172</sup> setting out “long-term approach to making decisions on the amount and timing of returns to shareholders, including dividends, share buybacks and other capital distributions within the context of any relevant legal or financial constraints.” I have no strong view on this matter.

**19.13** In the event that a company becomes insolvent within two years of paying a dividend, and it can be proved that the payment of those dividends was a material contributing factor in the insolvency, the directors would be open to legal challenge.

**19.14** I have not framed my thoughts in this section as formal recommendations as I am aware that work is underway in BEIS on the issues arising here and that it has made a commitment to the BEIS Select Committee. I hope nonetheless that BEIS will consider positively adopting the approach I have outlined.

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<sup>172</sup> Investment Association, *Shareholder Votes on Dividend Distributions in UK Listed Companies – The Case for a Distribution Policy* (May 2019)

## 20. Alternative Performance Measures and Key Performance Indicators

**20.0.1** Increasing use is being made by boards and managements, in shareholder and other communications, of Alternative Performance Measures (“APMs”). They are defined by the company itself with no IFRS or UK GAAP basis, but for many large listed businesses these are important indicators for management, investors, analysts and other interested parties. This is particularly true at Investor and Capital Market Days, in the front end of the Annual Report and in preliminary and other announcements. The strategic report also contains Key Performance Indicators (“KPIs”).

**20.0.2** Where used with precision, APMs and KPIs are two different things, though often APMs will also be used as KPIs in company disclosures.

Examples of APMs	Examples of KPIs
“Non-GAAP” metrics	GAAP metrics
“Adjusted”, “Underlying” or “Operating”	Environmental or employee metrics
EBITDA, EBIT	Sector-specific measures, such as: RWAs, same store sales, oil reserves etc

### 20.1 APMs

**20.1.1** APMs are generally adjusted forms of headline IFRS or UK GAAP numbers, reflecting adjustments that management argue make the underlying performance of the company more visible. They are not endorsed by accounting standard setters. They include such familiar concepts as EBITDA.

**20.1.2** It has been argued by some respondents to the Call for Views that it would be useful to stakeholders if there was clarification published as to which of these measures have been subject to assurance of any sort and what level of assurance had been obtained. The survey of investors<sup>173</sup> commissioned for this Review found that, whilst for many trust overall remains reasonably high, for some “trust is lessened by the use of APMs (and their resultant impact on remuneration)”.<sup>174</sup> Furthermore, 93% would welcome some change to the scope of assurance<sup>175</sup>, with the additional scrutiny of APMs and KPIs used in remuneration topping the list.<sup>176</sup>

<sup>173</sup> The investor survey indicated that investors were cognisant of the need to balance increased costs and time with increased levels of assurance. The majority of views fell in the middle of a spectrum which ranged from complete freedom for management’s own narrative through to ‘the more assurance the better’.

<sup>174</sup> Morsfield & Thomas *ibid*

<sup>175</sup> Morsfield & Thomas *ibid*

<sup>176</sup> Morsfield & Thomas *ibid*

**20.1.3** APMs are defined in guidance<sup>177</sup> issued in 2015 by the European Securities and Markets Authority (“ESMA”) as follows: “an APM is understood as a financial measure of historical or future financial performance, financial position, or cash flows, other than a financial measure defined or specified in the applicable financial reporting framework” and “APMs are usually derived from (or based on) the financial statements prepared in accordance with the applicable financial reporting framework, most of the time by adding or subtracting amounts from the figures presented in financial statements.” ESMA goes on to give various examples including operating earnings, cash earnings, earnings before one-time charges, EBITDA, and net debt. It requires (i) that the method of calculating the APM be transparent, (ii) the use of any APM is explained, (iii) the APM is fully reconciled to the relevant GAAP numbers and (iv) that APMs are reported consistently over time.

**20.1.4** The use of APMs has possibly contributed to suspicion about executive remuneration and, in order to achieve complete clarity, users deserve more certainty over the use of these APMs. There is a further good reason for APMs to be audited as they frequently provide the principal avenue of communication of company performance. Accordingly,

**20.1.5 I recommend that Alternative Performance Measures should be subject to audit.**

**20.1.6** Such an audit should not only verify that the underlying calculations have been properly executed but also that no misleading information has as a result been disseminated.

## 20.2 KPIs

**20.2.1** KPIs are measures of business performance, which may be but do not need to be associated with numbers in the financial statements. In the UK the disclosure of a small number of these is required in the strategic report. KPIs are less precisely defined, but s414C CA06 (as inserted by the regulations requiring the publication of a strategic report) provides a form of definition:

**20.2.2** “The review must, to the extent necessary for an understanding of the development, performance or position of the company’s business, include — (a) analysis using financial key performance indicators, and (b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.”

**20.2.3** It continues by stating that “key performance indicators” means factors by reference to which the development, performance or position of the company’s business can be measured effectively. s414CB inserts an important further phrase, “or the impact of the company’s activity”.

**20.2.4** In an FRC Report,<sup>178</sup> KPIs are defined as “quantitative measures used by directors to assess progress against objectives or strategy, track principal risks, or otherwise monitor the development, performance or position of the business. KPIs could include GAAP numbers, non-GAAP financial metrics or wider metrics.”

<sup>177</sup> ESMA Guidelines on Alternative Performance Measures (5 October 2015)

<sup>178</sup> Financial Reporting Lab, *Performance metrics – Principles and practice*, pg. 23, (November 2018)



**20.2.5** The FRC, in guidance on writing the strategic report,<sup>179</sup> states that “these will generally be the performance measures or risks considered by the board.” It defines the term “key” as referring to facts or circumstances that are (or should be) considered material to an understanding of the development, performance, position or future prospects of the business. Note the addition of “future prospects”.

**20.2.6** It goes on to say that these KPIs “should be those that the directors judge are most effective in assessing progress against objectives or strategy, monitoring principal risks, or otherwise utilised to measure the development, performance, or position of the entity ... where possible the KPIs should reflect the way that the board manages the entity’s business.”

**20.2.7** I consider that shareholders should be given the opportunity to ask for assurance around KPIs, via the Audit and Assurance Policy, but where the KPIs are used for the purposes of determining remuneration they should be subject to audit. Thus,

**20.2.8** I recommend that any Key Performance Indicators used for the purpose of calculating executive remuneration should be subject to audit.

**20.2.9** It is relevant that the investor survey showed that many investors broadly treat APMs and KPIs as essentially the same. However, some investors acknowledged that KPIs can be inherently harder to assure than APMs. Some investors also voiced concern about a loss of useful information if KPIs were subject to a formal assurance process. It may take time, but as the recommended new auditing profession becomes established, new auditors, capable of auditing the non-financial KPIs, will come to be authorised.

## 20.3 Risk Weighted Assets

**20.3.1** The regulation and oversight of the financial services sector differs from that for other corporates with the Senior Managers and Certification Regime<sup>180</sup>, the use of s166<sup>181</sup> “skilled person” reviews and intense supervision of risk management.

**20.3.2** It has been suggested that auditors should provide an opinion on the truth and fairness of the calculation of risk weighted assets in banks. This is not straightforward. The models that lie behind the calculation of risk weighted assets can run to many hundreds of pages of explanation and are already considered by the PRA in its assessment of the capital adequacy of banks. This process is already very onerous and I consider that it would involve a disproportionate additional cost to insist that an extra layer of assurance is added beyond that provided by the PRA, although, of course, it will always be open to bank audit committees to choose in their Audit and Assurance Policy to detail additional procedures in relation to the RWA calculations, reflecting some current practice. At a practical level also, the depth of skills necessary to undertake such separate assurance are not obviously widespread and readily available. Nonetheless, the extent to which the financial statements reflect the reality of a bank’s financial strength makes the role of risk weighted assets particularly important. Accordingly, it would be appropriate for consideration to be given by the PRA to the possibility of sending the auditor a letter of comfort (as an input to the auditor’s assessments) regarding the work it has undertaken in relation to validating the models from which the risk weighted assets are derived.

**20.3.3** I note in this context that the PRA has recently written to regulated firms indicating its intention to make greater use of the s166 process to ensure an improvement in regulatory reporting.

<sup>179</sup> Financial Reporting Council, *Guidance to companies on writing a strategic report*, 5.9 (updated July 2018)

<sup>180</sup> The extended Senior Managers and Certification Regime is effective from 9 December 2019.

<sup>181</sup> s166 of the Financial Services and Markets Act; see <https://www.fca.org.uk/about/supervision/skilled-persons-reviews>

## 21. Payment Practices

**21.1** Late payment to suppliers continues to be a matter of concern, as highlighted in recent reports by both government<sup>182</sup> and Parliament<sup>183</sup>, despite actions taken by successive governments in recent years to address this issue. Government's response of June 2019 to its latest call for evidence<sup>184</sup> on payment practices found that 97% of suppliers surveyed had experienced late payments from business customers, while only 11% thought matters had improved in the past three years.

**21.2** This is an issue of relevance to this Report, not just because of the damaging impact on suppliers facing late payments, but because a poor, or worsening, approach to paying suppliers may indicate that a company's own financial position is deteriorating. It is therefore of interest to a company's shareholders, and other users of the annual report and accounts, and clearly the suppliers themselves.

**21.3** There is, however, very limited detail on companies' payment practices and track records within the existing annual report and accounts. I understand that only a handful of FTSE-350 companies provided details in their most recent annual reports about their compliance with the Payment Practices Reporting Duty ("PPRD") and the Prompt Payment Code (where applicable). It is also the case that PPRD reporting is provided through a government website only, at an individual registered company level, which can make it hard for shareholders and other interested parties to determine the overall payment performance of a group with several subsidiaries.

**21.4** It would be of value if existing company reporting on supplier payments was given greater visibility and prominence within the annual report. Therefore,

**21.5 I recommend that directors report to shareholders on their company's payment policies and performance and that this be subject to some level of audit, as described in the company's Audit and Assurance Policy.**

<sup>182</sup> Government response to *Creating A Responsible Payment Culture: A Call For Evidence In Tackling Late Payment* (June 2019).

<sup>183</sup> BEIS Select Committee, *Small Businesses and Productivity* (November 2018).

<sup>184</sup> Letter from Kelly Tolhurst MP to Rachel Reeves MP (June 2019).

## 22. Whistleblowing

**22.1** It seems strange that, whilst whistleblowing protections have been enshrined in law,<sup>185</sup> these protections do not generally extend to whistleblowing to auditors.

**22.2** PID provides the statutory framework for whistleblowing by employees. It protects employees from dismissal or other detriment if they whistleblow based on a ‘reasonable belief’ that their company (or someone in it) has committed one of the following: (a) criminal offence (b) a breach of any legal obligation, (c) miscarriages of justice, (d) danger to the health and safety of any individual, (e) damage to the environment, or (f) the deliberate concealing of information about any of the above. It would be helpful to add a specific reference to deliberate misrepresentation of financial information.

**22.3** PID encourages employees to raise concerns with their employer in the first instance. There is also a list of ‘Prescribed Persons’<sup>186</sup> to whom employees can raise concerns directly; this includes the FRC. Employees may raise concerns directly with the FRC in relation to matters that are within the scope of the FRC’s statutory duties, including the monitoring of major and PIE audits.

**22.4** Appropriately the FRC (and other Prescribed Persons) have discretion over whether to take action in response to any whistleblowing, but must, in any case, publish an annual report of the numbers of disclosures they have received and what, if any, action they have taken in response. The BEIS Select Committee<sup>187</sup> noted that of 25 whistleblowing cases received in the past 10 years, only three cases resulted in action. If accurate, these numbers appear worryingly small and suggest that this process is not widely understood or applied.

**22.5** Audit firms or audit partners are not on the list of prescribed persons under PID. Employees may be protected if they raise concerns directly with the auditor but only “where the worker follows a procedure that has been authorised by his employer.” So, whistleblowing by employees directly to the auditor is constrained by whether the company chooses to put a formal mechanism in place to facilitate this.

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<sup>185</sup> Public Interest Disclosure Act 1998 (“PID”)

<sup>186</sup> “The Prescribed Persons Order 2014 sets out a list of over 60 organisations and individuals that a worker may approach outside their workplace to report suspected or known wrongdoing. The organisations and individuals on the list have usually been designated as prescribed persons because they have an authoritative or oversight relationship with their sector, often as a regulatory body.” Relevant disclosures to a Prescribed Person are generally protected under the Public Interest Disclosure Act 1998. Prescribed Persons are required to produce an annual report on whistleblowing disclosures made to them by workers.

<sup>187</sup> BEIS Select Committee *ibid*

**22.6** This seems an unnecessary encumbrance and accordingly,

**22.7** I recommend that the relevant Statutory Auditor for a particular audited PIE be added to the list of Prescribed Persons under the Public Interest Disclosure Act.

**22.8** Not only employees may have information relevant to the audit and so,

**22.9** I further recommend that the protections available to employees should be extended to others with a direct economic relationship with the entities being audited. These would encompass shareholders, suppliers, customers and any other creditors. Such individuals should also be afforded protection when whistleblowing to ARGA.

**22.10** In order to protect against this process being abused, the protection of PID would not be available if the action was deemed to have been undertaken for the purpose of stimulating needless publicity for defamatory reasons.

**22.11** I believe that whilst audit is legally defined to be used by a narrow section of society – shareholders – the application of PID to a wider population will emphasise the societal importance of the audit.

**22.12** Criteria will need to be developed to guide the limits of whistleblowing to meet a materiality test. Clearly, for example, the communication of matters which may threaten the existence of the business, or relate to the behaviour of the audit committee as complicit in wrongdoing, would pass such a test.

**22.13** Finally, ARGAs may wish to consider how it publicises the rights of whistleblowers and, learning a lesson from the United States, whether it ought to operate a reward programme for specific instances of whistleblowing.

## 23. Resignation or Replacement of Auditor

**23.0.1** One aspect of informing the users of audit comes when an auditor resigns. However, it is difficult not to conclude that, generally, insufficient information is shared about the reasons for the resignation of an auditor.

**23.0.2** I have found that the existing requirements for PIEs and their auditors to notify the FRC of the reasons for an auditor ceasing to hold office are neither well understood, nor, if understood, consistently followed. In passing I also note that the requirements for notifications relating to non-PIEs (which, where required, should be sent to the professional body with which the outgoing auditor is registered) are more complex still.

**23.0.3** I understand that the FRC has not been receiving all the required notifications in a timely manner. Whilst the FRC's current approach of engaging with auditors to help improve their understanding and their processes is welcome, there is a need for a tougher approach, including the use of sanctions. This may mean that ARGAs need to be freed from restrictions on sharing information internally for this purpose.

**23.0.4** The vast majority of resignation statements say little of any substance. This sparseness of information occurs despite the specification in the Guidance to the Deregulation Act 2015 that, if the auditor thinks that there are related matters which are not the auditor's actual reason for demitting, these should be included in the resulting s519 statement.

**23.0.5** If, as I argue, audit should be designed as a process intended to inform then such a statement would provide an important opportunity for auditors to raise concerns and a reason for shareholders to ask questions.

**23.0.6** Any auditor wishing to resign may do so by sending a notice to that effect to the company. The notice may take effect immediately or at a later date if specified within the notice. If the company is a PIE then the notice will not take effect unless it is also accompanied by a statement from the auditor setting out the reasons for resignation and whether there are any matters that the auditor considers need to be drawn to the attention of the company's members or creditors. It is then the company's obligation to send a copy of the statement to everyone who is entitled under s423 CA06 to receive a copy of the accounts.

**23.0.7** There are appropriate exemptions for such matters as the company no longer falling within the audit regime, or the replacement of a subsidiary auditor by the company's existing group auditor where there are no matters that need to be drawn to the attention of the company's members or creditors.

**23.0.8** The s519 statement is still required if there is no resignation, for example if the auditor simply chooses not to seek reappointment. However, practice suggests this process is remarkably uninformative. In a high profile resignation in August 2019 the s519 statement merely said: “Following a review of our client portfolio we have chosen not to seek reappointment as auditors.”<sup>188</sup>

**23.0.9** The issue of resignation illustrates that auditors’ first instincts are not always to inform and the lack of clarity in the reasons required to be given for resignation (e.g. for commercial reasons) contributes to the difficulty of improving audits. It must also be problematic for those bidding to replace the departing auditor.

**23.0.10** I was struck recently by the reporting of the 1MDB scandal in Malaysia, in which three successive Big 4 auditors<sup>189</sup> were removed by the company for voicing legitimate concerns over the existence of particular assets. In this example, perhaps, if there had been greater transparency around the reasons for departure of the first auditor, the second and third might have approached possible engagement in a different way before taking on the audit and the alleged scandal might have surfaced much sooner. I would like to think that a scandal of such magnitude could not occur in the UK, and yet if we persist in allowing auditors to use boilerplate resignation statements, I cannot be sure.

**23.0.11** With the aim of ensuring shareholders and other stakeholders receive timely information,

**23.0.12** I therefore recommend that amendments are made to the Companies Act to clarify and strengthen the process by which auditors and companies inform shareholders and other stakeholders of an auditor’s resignation, dismissal or decision not to participate in a retender.

**23.0.13** In making such an amendment, a requirement should be incorporated for the auditor, as a minimum, to respond to the following questions in the case of a decision to resign or not to participate in a retender:

- Was the decision caused by a disagreement with the audit committee?
- Was the decision caused by the withholding of information by the company<sup>190</sup>?
- Was the decision caused by the unwillingness of management to cooperate with the audit?
- Was the quality of the processes in the audited company such that the effort of auditing this company was greater than average and not reflected in the fees?
- Was there an issue of trust between auditor and either management or the board?

<sup>188</sup> Grant Thornton letter to Sports Direct (13 August 2019)

<sup>189</sup> See for example, Tom Wright & Bradley Hope, *Billion Dollar Whale*; Hatchett Book Group Inc, pp 145-6, 272 (2018)

<sup>190</sup> Already a potential criminal offence under s501 CA06

## 23.1 A General Meeting

**23.1.1** The resignation or dismissal of an auditor makes a powerful statement. To ensure a full opportunity for the reasons to be completely understood, other than when an irresolvable conflict of interest has arisen or a rotation of auditor is mandated,

**23.1.2** I further recommend that on the resignation or dismissal of its auditor a company would be required to hold a General Meeting, within 42 days of receiving the letter of resignation or sending a notice of dismissal, at which the departing auditor would be required to answer questions from shareholders; the Board would be required to explain how it proposes to appoint a new auditor and manage the transition, consistent with its Audit and Assurance Policy.

**23.1.3** At present an auditor who has resigned has the right to demand that the directors call a general meeting to “receive and consider an explanation of the reasons for, and matters connected with, his resignation.”<sup>191</sup> The auditor can request that a statement of a “reasonable length” be circulated to all the members who have received notice of the meeting.

**23.1.4** Shareholders in all companies have the right to remove an auditor via special notice of a General Meeting (s510 CA06) with the auditor having rights to attend and make a statement. Furthermore, s511A CA06 gives ARGAs or a minority of shareholders (minimum 5%) the right to apply to a court to have an auditor removed if they believe there are proper grounds for doing so.

**23.1.5** For listed companies similarly qualifying shareholders have the right to have their concerns about the work of an auditor published in a statement on the company’s website prior to any general meeting at which accounts are to be laid (s527 CA06). It is an indictment of the investment community that despite all the recent scandals this power is rarely if ever used. I hope that shareholders will recognise this failure as an opportunity to improve their engagement on all issues of audit. I hope also that by engaging, for example, the Investment Association in the work to put these recommendations into effect, understanding of audit issues will improve amongst the investment community.

## 23.2 Tenure

**23.2.1** It has been suggested to me that there would be advantages to auditors having five year appointments rather than annual ones as now.

**23.2.2** Anecdotal evidence may indicate that reporting has been stronger where the auditors feel they have nothing to lose; proponents of this view also say that they observe the way auditors speak about their concerns of damaging their relationship with the company. It has been suggested that a five year appointment would strengthen the resolve of the auditor during the life of the appointment, resulting in a tougher and fuller audit, and more worthwhile reporting. It is claimed that resignations within that five year appointment period would be much more visible and so gain greater attention. With less of an annual routine there could be more engagement from shareholders.

**23.2.3** On the other hand, directors are subject to annual reappointment votes, and audit partners are already on a five year rotation cycle. If auditors are being faithful to the Principles of Corporate Auditing, then there should not be any effect on behaviour of one or five year appointments. Furthermore, others argue that the longer the contract, the more the probability of cosiness or complacency.

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<sup>191</sup> s518 CA06

**23.2.4** On balance, I see no compelling case to alter the present arrangements but if shareholders consider this is important then there is nothing to stop them attempting to achieve it.



## 24. Technology

**24.0.1** Technology is already widely used across auditing, with very different levels of investment between the Big 4 and other firms, both “in the form of task-specific software to perform assessment of acceptance/continuance of an audit engagement as well as more comprehensive audit documentation platforms supporting the design and execution of the audit process.”<sup>192</sup> For the largest audit firms these platforms take the form of proprietary software. The profession has come a long way from “holler and tick” where one person would call out from a ledger, ticks would be marked and a search made for unmatched transactions.

**24.0.2** There appears to be a widespread consensus that automating existing data related audit tasks is underway and its extension inevitable. The primary use of new technology tools to date is for risk assessment purposes but such activities as the use of drones for audit stock count purposes can be expected to become more prevalent. Some claim that the tools already exist that can extract and standardise company data, mapping and tagging it directly from the company’s accounting system.<sup>193</sup>

**24.0.3** Journal entry testing often uses data analytics to assist auditors in assessing fraud risk arising from management override of controls. The FRC stated in 2017 that “the development of standard tools for general use by audit teams can be traced back to early 2005 following the introduction of the specific requirement to test the appropriateness of journal entries as part of the auditor’s responsibilities in relation to fraud (ISA 240). Firms introduced standard tools to facilitate the audit of journals in line with ISA 240 together with specialised support to aid in capturing the data and loading it into such tools...Continuing technological developments mean it is now easier (although not without challenge) for an auditor to capture, transform, store and analyse entire datasets than previously, allowing for the interrogation of 100% of the transactions within a population.”<sup>194</sup>

**24.0.4** The use of such techniques has grown significantly since that report less than three years ago. As such technologies become widespread in use, stretching beyond journal testing, they will clearly have an impact on the cost of audit (less human checking) and on the depth of testing that will be possible.

**24.0.5** At the same time there is some evidence of offshoring by auditing firms of some of these activities and I encountered some anxieties about the extent to which this process, and automation generally, threatens the development of experience by younger auditors. Firms will need to take care that judgment is not devalued as technology develops. The education

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<sup>192</sup> Submission by Mark Edmondson, President & CEO, Inflo (6 June 2019)

<sup>193</sup> Submission by Validis (6 June 2019)

<sup>194</sup> Financial Reporting Council, *Thematic Review on use of Data Analytics* (January 2017)

curricula for the new profession will have a key role to play as more technologists enter the auditing profession. ARGA will need to be alert to the evolution and role of algorithms as more reliance is placed on them.

**24.0.6** Today, and historically, sampling of transactions has been the norm; “all firms have historically had some form of data extraction techniques, this is more often to select a relatively small sample and then to form some sort of audit conclusion based upon the sample selected.”<sup>195</sup> The statistical basis for this sampling was the topic of several academic papers in the 1990’s, which charted the development of statistical sampling from the 1930’s. The growing popularity of the audit risk model during the 1990’s is cited as part of a change to a “scientifically rational image”<sup>196</sup> of audit associated with the assessment of risk during audit planning, in which “the audit risk model replaces and subsumes the role formerly played by statistical sampling”. Regardless of the genesis, sample sizes today owe more to audit partners’ judgments than statistical analysis.

**24.0.7** For example, reconciliation of transactions to bank statements may occur over a relatively small sample of transactions, for perfectly understandable, practical and commercial considerations, but this process contributes to a misunderstanding of the role of audit. This sampling process at best only operates to a confidence level well below certainty. It is not clearly understood.

**24.0.8** However, it is now claimed that “more advanced analytics can trace 100% of transactions recognised in revenue through to cash receipt, allowing the auditor to focus on the revenue entries which are unusual or invest greater time testing revenue streams where revenue recognition is judgmental or has been adjusted”<sup>197</sup> and thus adding more value.

## 24.1 Obstacles to progress

**24.1.1** There are four obstacles to this development. First, the availability of the data in a usable form. Second, the willingness of companies to permit access to 100% of data. Third, the possible need to assure the systems used to create the standardisation and consistency of the data as presented for analysis, and, fourth, the need to assure the algorithms used in analysing the data to create conclusions.

**24.1.2** These developments also have an impact on the ability of the auditor to report on the adequacy of controls as they “can also provide valuable insight and information to the client, on both the number of exceptions and the effectiveness of their procedures, processes and controls in the areas being reviewed.”<sup>198</sup> These technologies do not replace the importance of the quality of the judgment of the auditor in understanding the implications of findings. Indeed Bryce Welker<sup>199</sup> specifically concludes that developments with Blockchain, for example, will drive the need for more highly qualified recruits into auditing and greater intensity of professional and business education as judgment will become even more important. As new technologist roles are embedded in audit teams, audit firms will need new people strategies. At one Big 4 firm, graduate intake in technology areas has quadrupled and younger auditors are being immersed in business issues and risks much earlier in the planning process.

<sup>195</sup> Andy Turner, *Audit of the Future*; Accountancy Age (12 June 2019)

<sup>196</sup> Michael Power, *Auditing Expertise and Sociology of Technique*; Critical Perspectives on Account, Vol 6, Issue 4 pp317-339 (1995)

<sup>197</sup> Info ibid

<sup>198</sup> Andy Turner ibid

<sup>199</sup> Bryce Welker, *What Blockchain means for the Future of Professional Auditing*; learn.g2.com (July 2019)

**24.1.3** Indeed, one firm told the Review that it sees time spent on the risk assessment procedures and audit planning stage rising from approximately 30% currently to as much as 60-70% in future.

**24.1.4** Data is increasingly available in digitally usable form, a trend that will only continue. However, ***ARGA may wish to consider stimulating the development of a standard method of data extraction similar to that developed by the US AICPA covering both structured and unstructured data.*** This area is not without controversy however, as some firms are developing their own proprietary platforms, whilst other participants outside the audit sector are funding work to create a common data model which could be applied to many areas of professional services, not just audit.

**24.1.5** ARGA will need to develop resources to ensure it keeps pace with developments in artificial intelligence and machine learning. Some would also say quantum computing is not far behind. There are also undoubtedly challenges around assuring algorithms that are beyond the scope of this Report.

**24.1.6** The second obstacle referred to here is more immediately practical. In the course of my work I learned of an audit firm that utilised audited company data obtained during their audit engagement to assess the value of cross-selling opportunities, including tax and transaction advisory services and after the conclusion of the audit engagement, without the company's knowledge. Another firm wished to use anonymised data obtained during audit engagements in order to "train" its proprietary machine learning tools, thus obtaining commercial benefit. I have been told that standard contractual terms and conditions prohibit this activity and explicit consent is required on a case by case basis.

**24.1.7** There are many complex issues about the use of data by auditors. Some may be caught up in GDPR questions and some in IP rights ownership. In order that the ability of technological innovation to improve audit quality is not restricted,

**24.1.8 I recommend that BEIS and ARGA work with auditors to create the necessary protections and policies for audit to be able to use data from the companies they audit in order to promote better quality audits.**

**24.1.9** Whilst some matters may be the subject of fierce competition between audit firms, I am persuaded that a profession-wide framework is also necessary.

**24.1.10** Given the developments towards considering 100% of transaction data, and in order to accelerate its adoption,

**24.1.11 I recommend that, in the audit report, auditors should explain the reasons for the necessity and basis of any sampling techniques used in conducting the audit.**

**24.1.12** This should assist in minimising the risks of a new expectations gap emerging based on over enthusiastic claims for new technology.

**24.1.13** In passing, I note that the auditor can require the provision of "such information or explanation as he thinks necessary for the performance of his duties"<sup>200</sup> but elsewhere there is a reasonableness test referring to "such information or explanations as he may reasonably require

for the purpose of his duties”<sup>201</sup> It would be desirable to consider further whether these two sections may be united by a reference to the professional judgment of the auditor, recognising that s500(1) is designed, in part, to assist with access to overseas information. There is at present an ability for an auditor to enforce his rights through the use of an injunction, but this is a cumbersome approach which could shatter relationships at a moment of particular importance.

**24.1.14** I understand from discussions with auditors that there is a relationship between audits with low AQR grades and the reluctance of junior auditors to join a particular audit team, with one key driver being the difficulty of obtaining information on a timely basis. This cannot be acceptable, and I suggest that ARGA works with audit firms to analyse the practicality of auditors keeping a log of requests for information (in some way graded for significance) and the time companies take to fulfil those requests. In most cases these logs would form part of the inspection process after the event, but I would expect that for entities it perceives as high risk, ARGA would require real-time disclosure from auditors about the timeframes for responses to their requests.

**24.1.15** Taken together these recommendations and suggestions should make the use of all transaction data easier.

**24.1.16** On the latter it may be important for ARGA to convene all the relevant software suppliers to develop standards for the processes of data extraction and distribution, whether on proprietary or open source software platforms or not. The option would then exist for shareholders to request assurance against those standards through their approval of the Audit and Assurance Policy.

**24.1.17** The table below<sup>202</sup> shows a sample of the marketplace solutions already available without enumerating those systems developed in-house by the Big 4.

Use Case/Need	Possible Solution(s)
Wizard-based full data set testing using Microsoft Excel for non-technical users	TeamMate analytics, ActiveData for Excel
Enterprise-class audit automation tools	Galvanize ACL Robotics, Caseware IDEA
Data extraction from documents, receipts and statements	Receipt Bank, AutoEntry
Trial balance extraction, data set import, and creation of basic lead schedules, analytical schedules, and other routine schedules	InFlo, CCH Audit Accelerator, Validis
Full data set analysis, unusual transaction identification, and data visualization	Inflo HI Mindbridge.ai
Bank statement and credit card retrieval from financial institutions	Hubdoc, File This Fetch. Receipt Bank Fetch

**24.1.18** What is clear is that “whilst much remains to be decided by the marketplace, the future of auditing will likely involve real-time transaction analysis, risk evaluation, and data evaluation...When block-chain based data repositories are more broadly used by mid-market companies, third party commercial tools will be required to help auditors evaluate the integrity of the data sets. As firms and their clients adopt more structured business process automation solutions (e.g. process workflows), process mining will further shift the landscape in favour of real time auditing.”<sup>203</sup>

<sup>201</sup> s500 CA06

<sup>202</sup> Brian Tankersley, *Automation and the Future of Auditing*; CPA Practice Advisor (August 2019)

<sup>203</sup> Tankersley ibid

**24.1.19** Some of this is not new but it is alleged that conservatism and an unwillingness to change existing models, and the difficulty of linking to large company systems with many accounting systems adapted to each individual company, has encouraged a focus on the mid-market for many of the available tools.<sup>204</sup> This would be disappointing.

**24.1.20** The use of AI to reveal patterns in data is also set to grow. Again, there needs to be assurance over the algorithms used. “Tech alone cannot transform audit. We have to take a white box approach. We need to be able to trace the algorithms through the system, and we have to understand how the system works. We can’t do it in a black box fashion.”<sup>205</sup>

**24.1.21** ISACA make a helpful point: “The assurance over ICT<sup>206</sup> relies on having sufficiently high technical awareness across the organisation, from the chairman to the doorman, to ensure people have a healthy balance of trust in, and scepticism of, the ICT outputs upon which they rely.”

**24.1.22** Whatever the outcome of all these developments I consider that they make the implementation of the Principles of Corporate Auditing even more important. Where new ethical and professional dilemmas arise the solutions should be tested first against these Principles. No algorithm should be permitted to behave unethically.

## 24.2 A new challenge for ARGA

**24.2.1** Technology developments create a new opportunity for confusion between audit and business services. Technology in the audit firms may exceed in capability that in the audited entities. In addition to creating new information, audit firms’ ability to test systems or recommend improvements and interrogate data in the interests of the audited entity will challenge a strict maintenance of independence. A more holistic view enabled by the use of technology may blur the distinction between audit and the provision of advice; ARGA will need to be alert to the inherent dangers this involves. This may become particularly relevant as technology assists in consideration of forward-looking information.

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<sup>204</sup> Comment from Jeff Gramlich, Validis (August 2019)

<sup>205</sup> Susan Coffey, EVP Association of International Certified Professional Accountants, Las Vegas Engage Conference, 2019

<sup>206</sup> Information and Communication Technologies.

## 25. Auditor liability and transparency

**25.0.1** In conducting this Review, I have encountered an almost continuous background of apparent anxiety about liability incurred by auditors that is said by many to prevent audit from being as useful as many would wish. Indeed, as a lay member of the Auditing Practices Board in the early 1990s I saw at first-hand how this “fear” inhibited the development of narrative auditor reporting. It is said that the present liability regime has led to standardisation of approach in order to protect against litigation.

**25.0.2** Since then, the firms conducting audit have mostly transformed themselves into LLPs<sup>207</sup>, thereby limiting liability to some extent. Furthermore, firms today have the ability to approach the companies they audit to seek a limitation of liability agreement (“LLA”), although very few, if any, have done so. Given that liability is held out to be such an extraordinarily important aspect of the world of audit, I find this surprising. One view is that boards feel they would be in breach of their fiduciary duties by recommending to shareholders that they agree to any limitation of liability for the auditor (I am also aware that the SEC in 2009 set itself against the use of LLAs). Perhaps it is time for a rethink.

**25.0.3** To free boards, if they wish, to make the case to their shareholders for the use of a Limited Liability Agreement for the auditor in line with the Audit and Assurance Policy,

**25.0.4 I recommend that s534 CA06 be explicit that a board that recommends, in good faith, the application of an LLA to its auditor is not in breach of its responsibilities.**

**25.0.5** Accurate analysis is hard to obtain but there is some anecdotal evidence that the liability carried by law firms has proved much more onerous than that said to be carried by audit firms. I understand also that the “Big 4” audit firms have built up substantial reserves in their captive insurance companies.

**25.0.6** I fail to understand why this liability risk, like others, is incapable of being priced in the business models of the audit firms.

**25.0.7** This year at least one firm<sup>208</sup> has written to audit committee chairs indicating a probable need to increase audit fees. Without transparency as to the profitability of audit, it is impossible for a rational analysis of the issue to be undertaken. That transparency has not been forthcoming

<sup>207</sup> For further discussion see Morris, P. and Stevenson, J., *Auditors, Negligence and Incorporation*; Business Law Review, 17(3), pp.54-57 (1996)

<sup>208</sup> EY (July 2019)

through the firms' transparency reports. Of course, calculating profitability in today's business models is difficult but I see this as a necessary step to restoring confidence and trust. Many complex multinational businesses are able to do so.

## 25.1 Limiting liability

**25.1.1** In this Report, I have suggested areas for further audit and assurance. It would be most undesirable if fear of enhanced liability prevented them being adopted. I found widespread understanding that in extending the auditors' areas of operation it would be inappropriate to extend the present liability regime in the same way. Where an auditor opines on processes rather than outcomes there is definitionally more uncertainty and a simple best endeavours defence ought to be sufficient provided that the auditor's actions have been faithful to the Principles of Corporate Auditing.

**25.1.2** The time is right, at a moment when the auditors themselves have shown willingness to cooperate to improve audit, that a new dialogue begin to consider ways in which the liability regime may serve better the interests of producing higher quality and more informative audits. I encountered real investor scepticism that, if they were to accept limitation of liability, they would "get anything in return". There are a wide range of views on this subject.<sup>209</sup> If auditors can support the conclusions of this Report then,

**25.1.3 I recommend that ARGA facilitates a structured dialogue between investors and auditors to define a liability regime that would cause fewer obstacles to a more informative audit.**

**25.1.4** Such discussion would also need to deal with issues of liability potentially arising from the CMA's proposals regarding possible joint audits. It may also consider whether unlimited liability for Senior Statutory Auditors is a proportionate regime in which to encourage the brightest and best into the auditing profession, whilst the firm retains limited liability as a corporate body.

## 25.2 Greater transparency

**25.2.1** Audit firms are privileged to deliver a mandated product; they do so to give confidence in business and meet a public need. This privilege granted by law creates a market to serve the public interest. Given the public interest nature of the work it seems not unreasonable that society should have sight of the profitability of the activity (and the financial strength of the firms conducting it). Today's transparency reports from the major firms do not consistently distinguish earnings derived from audit from other activities and serve, in the area of audit, only to confuse further. I understand that at a time when the firms still conduct consulting and other services beside audit, an analysis of profitability is complex and involves allocation of overheads and shared costs. However, I am told that such accounts exist. Nevertheless, as long as that profitability is hidden, then a rational debate about liability is impossible.

<sup>209</sup> Limiting liability is an "unachievable 'magic bullet'", Jim Peterson, *Countdown* (2nd ed); Emerald Publishing (2017)

**25.2.2** Thus, in order that there is confidence in their activities and that a rational discussion can begin regarding liability,

**25.2.3** I recommend that firms conducting statutory audits of Public Interest Entities should publish separated financial information, including profitability, of the audit practice and that such firms should publish a remuneration policy and the annual remuneration of each relevant Senior Statutory Auditor.

**25.2.4** I note the comments of Phil Shohet that “audit firms need to develop far greater transparency around their activities and be able to explain how remuneration is not only driven by profit per partner, but also by the quality of the audits they deliver.”<sup>210</sup> To further aid understanding,

**25.2.5** I recommend that individual statutory audit reports detail the number of hours spent in conducting the audit by grade of auditor.

## 25.3 Audit Firm Culture

**25.3.1** There has been considerable discussion in the press around the culture prevalent in audit firms. In my Call for Views I did not expressly ask for views on this topic but in recommending the establishment of the Principles of Corporate Auditing I am implicitly seeking to influence that culture.

**25.3.2** It became apparent during my many meetings that there is still a deep-rooted culture that confuses who the auditor’s client is. Leaders in auditing need to take responsibility to ensure that there is no ambiguity: the CFO, for example, is not the client.

**25.3.3** In proposing greater transparency over the resources applied to audit, I hope also that the audit firms consider carefully their use and nurturing of junior auditing resource. To ensure that the auditing profession is an attractive destination for bright and able people, and that retention is enhanced, there may need to be a rethink about the hours worked and the pressures under which audit managers and junior auditors operate. They should also be encouraged to speak up about any concerns without fear of any adverse personal consequences.

**25.3.4** In the course of my work, I learned about “client profitability meetings” held to determine whether a firm would choose to pitch for a particular audit or not. The steady fees from audit were compared against lumpy but higher fees from consultancy, fund raising or structural work. A risk weighted net present value of these fees was created for both before a decision was made. Such a decision should not be needed in a world of proper independence.

**25.3.5** At one level it is encouraging that some audit firms are moving towards the sort of transparency that audited companies have been following for many years, particularly in remuneration. More needs to happen.

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<sup>210</sup> Phil Shohet, Foulger Underwood, *Is the number up for audit?*; Accountancy Age (October 2019)



## 26. The Regulator (ARGA)

### 26.1 Celebrate the good, chastise the bad

**26.1.1** For all the many criticisms of the Audit Quality Inspection process, the reality is that by calling out those audits that have failed to meet the desired quality standard, the FRC has performed an important service for all users of audit.

**26.1.2** It would also be very welcome if ARGA were to provide greater transparency over what it regards as good audits rather than appearing to place the vast majority of its emphasis on failures. This is not to hide failures, but rather to ensure that any disconnect between its view of good audit practice and the views of users can be debated openly with common understanding. It would also encourage good auditors and thus help to make the profession more attractive.

**26.1.3** *I welcome Professor Ramanna's<sup>211</sup> recommendation that regulators should "create a more affirming regulatory environment, one that rewards and not just punishes."*

**26.1.4** He continues, "a simple move would be to recognise highly effective audits as something more than 'compliant' (perhaps 'good') with a view to highlight and potentially disseminate emerging best practices in audit, especially when they involve clients with new production and revenue generation technologies."

**26.1.5** An increased celebration of "good" would be both encouraging and educational. However, I part company from Professor Ramanna over the use of the concept of best practice. I believe that this concept has been a pernicious addition to the lexicon and one that allows, indeed even encourages, lazy thinking. It is too seductive for people to retreat behind a best practice defence of their actions. What matters is that the right practice has been followed and that may well be different in different companies and at different times. What matters is what is right for a particular company, with its particular problems and its particular management at this particular moment given its particular circumstances. Best practice concepts drive out innovation as it is always safer to go with the herd and claim that an action is best practice rather than take a bolder and individual step. Best practice defences are based on backward looking analysis. Of course, good practice must be faithful to an enduring set of principles.

**26.1.6** It is notable that, in its 2018 Developments in Audit Report, the FRC stated the following: "We have added a separate section in each of our firm public reports to highlight where audit teams have performed high quality or innovative work. We also highlight good practice in the report that we provide to the Audit Committee Chair at the close of each of our individual audit inspections." Some examples of such good practices were also given.

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<sup>211</sup> Ramanna ibid

**26.1.7** The 2019 report<sup>212</sup>, however, focused on deficiencies rather than highlighting any good practices observed.

**26.1.8** In my view, more can and should be done.

**26.1.9** I recognise that there may be considered to be asymmetric risks involved in drawing attention to good audits. It is, however, just as important for ARGA to back its judgments publicly as it is for the auditors. That something may go wrong subsequently is one of the normal risks of professional life. In establishing ARGA, thought should be given to establishing any relevant and necessary safe harbour provisions.

## 26.2 Audit Quality Inspections

**26.2.1** There is some anxiety also that the present approach of the FRC to examining quality places pre-eminence on the process of performing audits over the outcome of audits (at minimum defensible opinions). According to one respondent, this is driving auditors to become good box tickers rather than good thinkers.

**26.2.2** This view is widely held. One senior auditor went so far as to say audit committee chairs were not concerned with the deficiencies in process that the FRC found and that, in consequence, a negative atmosphere was being fostered beyond that which would be useful.

**26.2.3** My team was given privileged and confidential access to anonymised FRC working papers and trawled through the details that had led to lower grade audits. They were satisfied that this description is not a fair reflection of the state of FRC inspections today. They found substance rather than form to be the driver of the conclusions.

**26.2.4** I spent time going through live audit files also and am satisfied that, whilst the spreadsheets involved are substantial and complex and undoubtedly serve the purpose of providing evidence of work done, they do not drive out the need for, and exercise of, judgment. The argument that file completion focuses attention in the wrong place is a matter for the leaders of audit teams: poorly led teams will fall prey to this syndrome whilst well led teams will take full advantage of the rigour involved. Leadership that is faithful to the Principles of Corporate Auditing, backed by good educational programmes, should help substantially to improve audit quality. Here the new profession should be a major assistance.

## 26.3 Engage the users

**26.3.1** ARGAs should also be open to engagement with concerned shareholders. 83% of those responding to the Investor Survey said they would find it definitely or potentially useful to have a channel via which they could raise concerns with the auditor and, if necessary, the regulator.<sup>213</sup> I have addressed the former and now,

**26.3.2** I recommend that ARGAs establish a formal confidential mechanism to interact with shareholders or other stakeholders to respond to concerns regarding particular audits.

**26.3.3** Such a mechanism could be linked to the new AURB recommended in this Report.

<sup>212</sup> *Developments in Audit*, FRC (November 2019)

<sup>213</sup> Morsfield and Thomas *ibid*

## 27. Audit & Risk Committees

**27.0.1** In this Report much reference has been made to the role of the audit committee. Jonathan Symonds, audit committee chair of HSBC, makes a powerful point: “It is the audit committee’s collective job to give the auditor courage.”<sup>214</sup>

**27.0.2** Audit committees generally meet several times throughout the year (the FRC’s guidance on audit committees<sup>215</sup>, covering premium listed companies, recommends a minimum of three meetings a year). Such meetings are typically substantive and wide-ranging, covering one or more of the following responsibilities of the Audit Committee:

- the tender process for the appointment of the external auditor;
- reviewing the company’s internal controls and risk management systems;
- assessing the integrity of the company’s financial statements and other financial announcements, including reviewing the significant financial reporting judgments contained in them; and
- monitoring and reviewing the external auditor’s independence and effectiveness.

**27.0.3** These functions are critical to providing assurance about a company’s resilience, yet the considerable work that goes into discharging them remains largely hidden.

### 27.1 Audit committee transparency

**27.1.1** It is true that the chair of the audit committee’s annual report to shareholders will summarise how the committee has addressed issues relating to financial reporting and risk. However, with some exceptions, these reports do not go much further than setting out that the Committee has undertaken various processes of review that have led it to be ultimately satisfied with the effectiveness of the external audit, the reliability of the company’s accounts, the management of risk and other matters.

**27.1.2** It would help strengthen confidence in the role of the audit committee if shareholders and other interested parties could gain some insight into **how** the committee has reached a successful conclusion regarding the company’s handling of financial reporting and risk. In particular, there would be value in understanding how the committee has, where necessary,

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<sup>214</sup> Comments to Investor Forum UK Bank Stewardship Summit (13 November 2019)

<sup>215</sup> Financial Reporting Council Guidance on Audit Committees (April 2016)

challenged the company's executives, its senior management, its internal audit function or its external auditor, in order to drive changes in behaviour or reporting for the benefit of the company as a whole.

**27.1.3** The discussions leading to such changes should normally be recorded, albeit in summary form, within the formal minutes of the audit committee meetings. These minutes may naturally set out initial differences of view or emphasis among the committee, and those invited to attend particular meetings, including management and the external auditor. I do not therefore agree, as some stakeholders have suggested, that the minutes of every Audit Committee meeting should be immediately published in full.

**27.1.4** However, I am of the view that there would be benefit in requiring publication of these minutes between a year and eighteen months after each meeting, with any redactions to be agreed in advance with the auditor and possibly with ARGA. The hurdle for consideration of redaction by ARGAs should be very high, partly to screen out frivolous requests and partly to discourage redactions in general. ARGAs would need to develop a test for probable detriment to shareholders.

**27.1.5** I recognise the risk that, faced with future publication, minutes will become more bland and less informative. Whilst this may be true, the remedy lies with shareholders who should not permit this behaviour.

**27.1.6** Accordingly,

**27.1.7 I recommend that audit committee minutes be published with a time-lag of 12-18 months and with approved redactions.**

**27.1.8** In the first instance, I recommend that this recommendation should apply only to premium listed companies which are bound by the Corporate Governance Code provisions and guidance on audit committees.

## 27.2 Audit committee functioning

**27.2.1** In my experience the detailed examinations that occur at audit committees are of such significance that non-executive directors who are not present are significantly disadvantaged in their ability to carry out their responsibilities effectively. Accordingly, it would be highly desirable if all audit committees were open to attendance by all non-executive directors.

## 27.3 Audit committee chairs and the risk of balkanisation

**27.3.1** It is an interesting by-product of guidance about the qualifications necessary to serve on an audit committee that this has been interpreted as the audit committee chair being the one with "recent and relevant accounting experience",<sup>216</sup> with the result that almost all chairs are now accountants, many of them former partners or employees of the Big 4. There is self-evidently a risk of inadvertently fostering groupthink or a perception of cosiness as a consequence.

**27.3.2** What is needed of an audit committee chair is that each is an experienced individual possessing an enquiring mind and the ability to make robust independent decisions. ***It would be helpful if ARGAs were to make clear that it is not necessary to be (or have been) a qualified accountant in order to deliver this role well.*** As more information starts to be audited, a non-accountancy mindset may indeed become an advantage.

<sup>216</sup> DTR 7.1.1 AR

**27.3.3** At the same time, *in developing corporate governance practices, ARGAs need to guard against the balkanisation of the board.* There are suggestions that in certain instances shareholders should vote against the re-election of the chair of the audit committee as a signal of displeasure with the work of the audit committee or its conclusions. The committee is not the creature of its chair and all members should share the same responsibility. The same comments apply to the board as a whole.

## 27.4 Audit & risk committees or risk committees

**27.4.1** Some companies have established separate audit and risk committees; others combine audit and risk in one committee. Whichever model is used it is important that the auditor is able to hear and participate in discussions at both. In some instances, the auditor attends the audit committee but not the risk committee. Given the importance of the Risk Report informing the audit plan it is important that the auditor is fully sighted on the discussions held between directors in these fora.

## 28. Implementation

### 28.1 Cost – benefit

**28.1.1** In constructing recommendations throughout this Report, I have been mindful to be proportionate and not to create new costs for business without justification. Consequently, many of the recommendations build on already available information and encourage improved communication.

**28.1.2** I consider that my recommendations for actions to be taken by companies and their boards would not create a significant extra cost other than where work that should be done is currently being neglected.

**28.1.3** For auditors, it is difficult to predict the future profitability model, with technology likely to reduce significantly some core costs whilst new activities would be likely to add cost. One likely consequence is much more focused and transparent fees negotiations which should lead to a better and more understandable balance between value for money and profitability.

### 28.2 Turning recommendations into action

**28.2.1** BEIS will, of course, need to consult on the detail of changes proposed but given how many Reviews have taken place the need for speed is evident.

**28.2.2** ARGA should have clear responsibility for driving the implementation of the recommendations of this Report, other than those involving a change in the law which require the involvement of BEIS. Neither AURB nor any new auditor Centre should have a formal role in the implementation process.

**28.2.3** The landscape of relevant auditable entities is complex. The terms of reference of the Review stated that “it will focus initially on the audit of Public Interest Entity companies whilst taking into consideration the effects on other relevant entities.” I have prepared this Report therefore to apply to Public Interest Entities. However, there are many other large enterprises which have importance to the UK’s economy, and which could reasonably be included in the first tier of applicability. I note also that BEIS is currently reviewing and might expand the definition of a PIE.

**28.2.4** Many of the recommendations will have much wider applicability, either on a statutory, regulatory or voluntary basis. In any consultations on implementation there will, of course, be the opportunity to define the relevant companies. ARGAs, the FCA and the Government should seek to implement these recommendations in a proportionate way taking into account the size and complexity of companies.

**28.2.5** The Principles of Corporate Auditing would, however, apply to the auditing of all companies whatever the structure of their ownership.

## 29. Conclusion

**29.1** I have laid out here a series of steps that taken together, I believe, will have the effect of improving both the quality and effectiveness of audit. I have looked beyond today's narrow definitions to create a landscape that will give boards the opportunity to acquire audit and assurance services specific to their requirements. I have also identified mechanisms for enhanced shareholder engagement to ensure proportionality. Finally, I have proposed an environment in which the status of an auditor will be enhanced and the creation of a profession that will be attractive to new entrants.

**29.2** I consider that these recommendations will enable the persistent debate since the publication of the MacFarlane report in 1992 to be brought to a conclusion. This is an important moment in the history of audit and it needs a genuine desire by auditors to grasp the opportunity this Report presents in the interests of both the users of audit and of their own profession.

**29.3** Some of the changes proposed will best be taken forward through legislation or regulations. Others will be capable of being progressed by ARGA. It will now be for the Secretary of State for BEIS to determine how this Report's recommendations can best be implemented.

**Sir Donald Brydon CBE**  
**London**  
**December 2019**



# Appendix 1 – Summary of responses to the Call for Views

## Chapter 1 – Definitions of audit and its users

Most respondents to this chapter felt that audit should serve a wider range of stakeholders beyond the company's shareholders, although those in favour of this (with a few exceptions) did not clarify whether the audit report should be explicitly addressed to other interested parties, nor whether auditors' liability should correspondingly extend to match the report being addressed to this wider range of interested parties. Only a minority of respondents offered a view on whether company law should be amended to set out more clearly the users of audit or its purpose, and those who did think the law should be changed did not in general offer concrete suggestions.

There was a roughly even split between respondents who thought audit should remain focused on the financial statements and those who would like it widened to providing confidence in the entity as a whole.

## Chapter 2 – The 'expectation gap'

There was a broad consensus that there is a 'gap' of some sort, with various suggestions for the types of 'gap' that may exist: expectation, quality, knowledge, delivery, evolution, performance, credibility etc. What divided respondents more was who or what is to blame for any perceived gap. A large number of respondents, particularly those from the company and audit side, called for users of financial accounts to be better educated on what audit is and what its limits are. Equally, there were many calls for audit to expand or improve to better meet the expectations of users, such as an 'enhanced framework' of accounting/auditing standards whose scope meets user needs, and/or through increased auditor scepticism.

## Chapter 3 – Audit and wider assurance

Respondents generally agreed that there is a desire for wider assurance. There was a mix of views on whether audit firms or third parties would be better placed to meet this need. Some thought that providing wider assurance within an expanded statutory audit model could provide more certainty and consistency; on the other hand, some were concerned that audit firms lack the skills needed for assurance on non-financial risks such as cyber security.

Most respondents accepted that audit and assurance can legitimately be tailored to address the risks of particular companies and sectors; provided that varying types of audit work, as inputs, still produced the same overall level of assurance as an output across all PIEs.

It was acknowledged that external auditors could make greater use of internal audit evidence, provided that the external auditor never relied exclusively on such evidence for any conclusion within the audit report.

## Chapter 4 – The scope and purpose of audit

There was a healthy level of response to the questions in this chapter, with many providing thoughtful and holistic assessments of the current audit and reporting environment with practical suggestions for improvement. In summary:

- **Internal controls** – there was general support for a proportionate regime that selects from the most useful parts of Sarbanes-Oxley, but with some anxieties expressed regarding cost and management time burdens. Responses tended towards the high-level rather than detailed commentary on what such a regime might look like in practice.
- **Going Concern** – there was a majority view that the current going concern reporting requirements are not fit for purpose, that the bar for identifying issues is set too high and comments that both directors' and auditors' reporting obligations should be clarified and extended to include more detail on uncertain events that could cast doubt on a going concern assessment.
- **Viability** – there was a consensus that the Viability Statement has not delivered what was intended and there were calls for it to be better aligned with business risks and to have better risk reporting, including of longer-term, less certain risks. Most responses reflected an understanding that the level of assurance would decrease the further into the future any assessment is made.
- **Unaudited information** – there was broad support for extending assurance to cover metrics which are material to successful delivery of a company's business model. There is particularly strong support from investors for this to focus on APMs and KPIs, especially those which are linked to remuneration, but emphasising that comparability is also important for investors to make best use of the information being assured.

## Chapter 5 – Audit product and quality

For many respondents, process was perceived to be getting in the way of auditor judgment and scepticism. Whether that arises from the standards, the regulatory model, the audit firms' own approaches or from behavioural biases was under more debate, but the underlying problem was widely acknowledged.

There was wide support for the disclosure of graduated findings and more discursive disclosure in auditor reports, not least as these would more closely reflect the non-binary nature of audit analysis and judgement, even if the headline opinion is binary. Many of those who said they opposed this appeared to be against a graduated opinion on the accounts which replaced or clouded the clarity of the top-level binary opinion, while not necessarily being opposed to more graduated findings alongside that opinion.

## Chapter 6 – Legal responsibilities

Responses to this chapter reflected the wide range of views on the issue of capital maintenance expressed during the Review's engagement activities. This included varying views on the differing objectives of international accounting standards and UK company law with regard to the determination of companies' unrealised and realised profits. There was, however, general agreement that enhanced transparency and assurance over companies' distributions would

be a positive step forward. Most respondents who mentioned this topic were of the view that such a disclosure should only be in relation to the parent company balance sheet but there was at least one exception calling for disclosures to be made for the parent, subsidiary and group accounts. In answering the 'books and records' question, many respondents referenced an intrinsic link between good internal controls and adequate accounting records.

## Chapter 7 – Communication of audit findings

Suggestions in this area included more year-on-year comparisons across annual audit reports; e.g. how does this year's financial position, and the accompanying key audit matters, compare to the previous year.

There was a strong message that AGMs are the right place for shareholders to raise issues regarding audit, and that these should be used better, rather than any new event being created. Some respondents called for greater auditor involvement at, and perhaps a dedicated audit element of, the AGM.

Many respondents noted a widespread lack of investor engagement or interest.

## Chapter 8 – Fraud

There was a recognition in many responses that users generally expect more from auditors regarding the detection of material fraud than is currently being delivered. One firm referred to a disconnect between public expectations and the current mindset of an auditor in relation to fraud detection under auditing standards, and stated that "standards and training for auditors have likely not kept pace with the current fraud environment".

A number of responses from audit firms showed a notable move away from the traditional position that the answer is to seek to change public expectations (rather than require auditors to do more). A recurrent message, however, was that any extension of auditors' responsibilities needs to be accompanied by greater accountability for directors through an internal controls attestation framework, to include anti-fraud controls. An academic stated that the problem is not users' expectations but rather that auditors are not fulfilling their existing responsibilities, with deficiencies in the auditing standard and related guidance contributing to a systemic failure to conduct effective fraud risk assessments that identify warning signs for material fraud.

## Chapter 9 – Auditor liability

There were no calls for further limitations on auditor liability and a clear consensus that this would be unlikely to lead to improvements in the quality or effectiveness of statutory audit.

It was noted by several respondents that the Big 4 audit firms have their own 'self-insurance' arrangements in place through captive insurance houses (which appear to be organised through the audit firms' international networks) and that these provide adequate levels of cover, at least for the existing statutory audit model. Few thought that any modest expansion of the scope of statutory audit would alter this picture significantly. Some felt that there was a marked lack of transparency regarding these insurance arrangements.

It was noted in various responses that challenger firms generally have to obtain cover in the market, with the main issue raised being the significant liability risks they may face by becoming a joint auditor for a large listed company under the existing joint and several liability model.

There was general support for the concept of companies being able to agree different liability arrangements for wider forms of assurance that auditors may be asked to provide.

There was some support for legislative changes to either codify/clarify or change the narrow position established by the *Caparo* case as to those to whom the auditors can be held legally liable.

## Chapter 10 – Other issues

### Technology

There were few responses on the subject of technology and audit. Of the those who responded, most outside the profession focused on the ability to look at all transactions, while the auditors believe technology has much broader application already. Almost all respondents commented that technology cannot substituted for professional judgment, although it may free up more time for such judgment to be exercised.

### Proportionality

There were very few specific ideas provided in response to this part of the Call for Views, beyond a call from some to tailor audit appropriately to the scale and complexity of the entity.

### Shareholders

Numerous responses to this section of the Call for Views commented that investors are not currently engaging sufficiently with the audit process and that existing channels for influence are not used. There was worrying ignorance about audit reports even from those few investors that have taken the time to respond. There was a belief that this level of investor engagement needs to change in order for recommendations in this regard to have substantive effect.

### Culture

There was no clear appetite for auditors to look at the culture of the firms they audit. The culture of the audit firms themselves was seen by some as needing improvement, e.g. to foster greater readiness and ability to exercise professional scepticism.

The transparency reports<sup>217</sup> produced by audit firms each year were generally said to be delivering appropriate insights into audit firm remuneration levels and structures, though whether these are read by many outside the profession is unclear.

### Costs

This topic garnered very few answers. Those received tended to be speculative in nature rather than based on experience, making it difficult to draw conclusions. The profession and some others used these questions to respond to other dynamics in the market, including the CMA recommendations.

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<sup>217</sup> The FRC has since published criticism of these reports, and pledged work next year to improve them. <https://www.frc.org.uk/news/september-2019/audit-firm-transparency-reports-not-visible-enough>

## Appendix 2 – Terms of Reference

### Independent review into the quality and effectiveness of audit

#### A. Purpose

The Secretary of State for Business, Energy and Industrial Strategy (BEIS) invites Sir Donald Brydon to conduct a review into the quality and effectiveness of audit.

The review process needs to be a thorough examination of the issues and allow for gathering evidence and consulting with stakeholders and experts. Sir Donald is expected to submit a report to the Secretary of State for Business, Energy and Industrial Strategy by the end of 2019. The final report will be published and the Government will consult on its response to the review's recommendations.

#### B. Review Objectives

The review is commissioned in response to the perceived widening of the “audit expectations gap” – the difference between what users expect from an audit and the reality of what an audit is and what auditors' responsibilities entail. Recent company failures have brought this gap into greater focus. There may be an additional gap between the information users of audited accounts believe is needed and what is available to them through audited financial statements or other publicly available information.

In general the audit opinion relates to past performance and the position of an entity at its balance sheet date. Expectations of audit and, more widely, assurance are growing and it is important that the audit responds effectively to those expectations.

The review is intended to take a fresh look at the scope of the audit, how far it can and should evolve to meet the needs of users of accounts, what other forms of assurance might need to be developed, and to define and manage any residual expectations gap. It will test the current statutory audit model and ask whether it can be made more effective as currently established or whether it requires amendment. It will consider how the audit product should be developed to serve the public interest in future, taking account of changing business models, new technology and stronger public expectations.

It is intended that as a result of the review's recommendations any expectations gap will be better understood and users of accounts will have greater assurance about the future of the entity concerned.

## C. Scope

The review's scope is taken to include the objectives and context included in these terms of reference.

The objectives of the review are ambitious and will result in the need to consider, amongst other things, the following:

1. Understanding the needs and expectations of stakeholders who make use of company audits:
  - a. The origins and perceptions of the expectations gap; and
  - b. What can be done to ensure that investors and other stakeholders fully engage with audit and understand its scope and limitations.
2. The scope of audit:
  - a. What information future investors and the users of corporate information are likely to require a company to produce (drawing on the work of the FRC in this regard) and, in that context;
  - b. what assurance investors and other users of corporate information will need; and
  - c. how any extension of that assurance can be achieved at a proportionate cost to corporates.
3. How assurance is provided and how that assurance can be made more effective for investors:
  - a. From whom and how the assurance should be provided;
  - b. The extent to which auditors can and should assess whether underlying information is reliable;
  - c. The extent to which auditors can and should assess the impact of uncertain future events; and
  - d. How audit can respond to the opportunities and challenges of new technology and other forms of innovation to increase the assurance and effectiveness of audit.
4. How any change to the current statutory audit model will impact on potential liability of auditors.
5. How communication of audit finding to users can be improved to enable that information to be of more use.
6. The potential benefits and opportunities for international engagement and cohesion across the world on auditing standards.

The review will coordinate its work with the ongoing work of the FRC and will focus initially on the audit of Public Interest Entity companies whilst taking into consideration the effects on other relevant entities. It will also consider the proportionality of the balance in terms of cost to produce against benefits to the users in making recommendations.

## D. Context

The present review is launched in the context of the Independent Review of the Financial Reporting Council which commented on the need for this review to be "driven by the interests of consumers and users of audited figures, not producers or the audit profession." It is also launched in the context of the Update Paper, "Statutory audit services market study" published

by the Competition and Markets Authority which commented on the need to clarify “what an audit is supposed to achieve on a conceptual level and ... how audits might best serve shareholders (and ultimately the public interest).”

The government’s expectation is to see the UK at the forefront of corporate governance internationally. This includes maintaining a leadership position internationally in terms of the evolution of the audit.

## **E. Governance**

The review will be led by Sir Donald Brydon.

The Independent Reviewer will be supported by Advisory Groups that will advise on the direction of the review and sources of evidence and will help to scrutinise and challenge emerging findings and recommendations. It is anticipated that in addition to a user dominated group, there will be an audit profession group and a technology group, the precise structure of which remain to be determined.

## **F. The Review Secretariat**

The review will be supported by a small dedicated Secretariat acting in support of the Independent Reviewer.

The review is endorsed by BEIS, the Financial Reporting Council (FRC), the Institute of Chartered Accountants in England and Wales (ICAEW) and the Investment Association. The secretariat may therefore include secondees from the Financial Reporting Council, BEIS and members of the Investment Association, to ensure that the review has access to knowledge and expertise from the audit, accounting and investment professions.

The Institute of Chartered Accountants of England & Wales has also agreed to provide £500,000 of funding for use on the review.

All supporting organisations recognise and accept that their contribution to the review is unconditional. The review will be conducted on an independent basis.

## **G. Stakeholder Engagement**

The review will undertake engagement with a wide range of stakeholder groups in order to fully understand the range of issues, and ensure constructive challenge.

## Appendix 3 – Advisory Board and Auditors’ Advisory Group

### Advisory Board

Luke Chappell

Carole Cran

Margaret Ewing

Simon Fraser

Mark Freedman

Alison Hopkinson

Professor Chris Humphrey

Emme Kozloff

Natasha Landell-Mills

Michael McLintock

Julia Wilson

### Auditors’ Advisory Group

Hywel Ball

Steve Gale

Annie Graham

Michael Izza

Scott Knight

Gilly Lord

Maggie McGhee

Mark Rhys

Phil Smart



## Appendix 4 – List of respondents

Submissions can be found online at <https://www.gov.uk/government/consultations/the-quality-and-effectiveness-of-audit-call-for-views>

38 Degrees	Chartered Institute of Internal Auditors
Aberdeen Standard Investments	Chartered Institute of Management Accountants
Accountancy Europe	Chartered Professional Accountants Canada
American Institute of Certified Public Accountants (AICPA)	ClientEarth
Anglo American plc	Corporate Reporting Users' Forum (CRUF)
Association of Chartered Certified Accountants (ACCA)	CPA Australia Ltd
Association of Investment Companies	Croda International plc
Association of Practising Accountants	Crowe U.K. LLP
Audit Committee Chairs' Independent Forum (ACCIF)	Deloitte LLP
Audit Scotland	Department for Digital, Culture, Media and Sport
Australian Institute of Performance Sciences	Diageo plc
Aviva Investors	Duncan & Toplis Limited
BDO LLP	Ernst & Young LLP
BP plc	Eumaeus
Buzzacott LLP	GC 100
CBI	General Council of the Bar of England & Wales
CFA Institute	Grant Thornton LLP
Chartered Accountants Australia and New Zealand	Halex Consulting Limited
Chartered Accountants Ireland	Hermes Investment Management Limited

HSBC Holdings plc	RSM
HW Fisher & Company	Santander UK Group Holdings plc
Independent Audit Limited	Sarasin & Partners
Information Assurance Advisory Council	Schroders plc & Schroders Investment Management
Institute of Chartered Accountants England & Wales (ICAEW)	Severn Trent plc
Institute of Chartered Accountants Scotland (ICAS)	Smiths Group plc
Institute of Chartered Secretaries and Administrators (The Governance Institute)	Social Market Foundation
Institute of Directors	Tesco plc
International Auditing & Assurance Standards Board (IAASB)	The 100 Group
International Ethics Standards Board for Accountants (IESBA)	The CityUK
International Federation of Accountants	The Global Accounting Alliance
The Investment Association	The Global Public Policy Committee (GPPC)
ISACA	The Sage Group plc
Johnson Matthey plc	Unilever plc
KPMG LLP	UK Shareholders' Association & ShareSoc
Kreston Reeves LLP	Validis
The Law Society	Z/Yen Group Limited
Lloyds Banking Group plc	<b>Individuals</b>
Local Authority Pension Fund Forum	Individual 1
London Stock Exchange Group plc	Individual 2
Mazars LLP	Peter Bebb
Mindbridge Analytics, Inc.	Richard Brooks
National Grid plc	Baroness Bowles
Pricewaterhouse Coopers LLP	Stephen Clapham
Qinetiq plc	Alexander Couter
Quoted Companies Alliance (QCA)	David Damant
Royal Bank of Scotland plc	Mark Edmondson
Reputability LLP	Jane Fuller
Rio Tinto plc	Ross K Graham
Royal Dutch Shell plc	Jon Grant
	Prof David Hatherly
	Simon Henry

Melanie Hind

Donald Jeffrey

Martyn Jones

Dr Rasha Kassem

Keith Kauffman

Rick Kravitz

Natasha Landell-Mills et al

John Levett

Prof Sir Andrew Likierman

Filip Lyapov

Dr Stuart Marsh & Dr Christopher Kelsall

Graham Page

Ralph Tiffin

Dr Dorothy Toh

Eric Tracey

Stuart Turley, Christopher Humphrey & Javed Siddiqui

Herman van Brenk et al

Stuart Wallace

Kris Wilcox

## Appendix 5 – Recent projects relevant to Review

### **Commissie Toekomst Accountancysector (The Netherlands)**

#### **Competition and Markets Authority**

Statutory Audit Market Study

#### **Corporate Reporting Dialogue**

Better Alignment Project

Driving Alignment in Climate-related Reporting

#### **European Commission**

Guidelines on reporting climate-related information

#### **European Corporate Reporting Lab @ EFRAG**

Project on Reporting of non-financial risks and opportunities, and linkage to the business model

Project on Climate-related reporting

#### **European Securities and Markets Authority (ESMA)**

Consultation Paper on MAR Review Report

Consultation Paper on Guidelines on prospectus disclosure

European Single Electronic Format implementation

#### **Financial Reporting Council (Australia)**

Auditor Disciplinary Processes: Review

Audit Quality Action Plan

#### **Financial Reporting Council (FRC)**

Future of Corporate Reporting Project

Consultation on the proposed revisions to the CASS standard

Consultation on Revisions to Ethical and Auditing Standards 2019

Consultation on Revising Standards for Investment Reporting

Exposure Draft: Proposed ISA (UK) 570 (Revised) – Going Concern

#### **Financial Reporting Lab**

Project on Digital Future: Structured experience

Project on Climate reporting

Project on Workforce reporting

Project on Disclosure of business models, strategy and the longer-term

#### **Independent review of the Financial Reporting Council**

**International Accounting Education Standards Board (IAESB)**

IESs 2, 3, 4 and 8 reviewed on Information & Communications Technology

IES 7 on Continuing Professional Development

IESB 2, 3, 4, and 8 reviewed on Professional Skepticism

**International Accounting Standards Board (IASB)**

Disclosure Initiative

Accounting Policies and Accounting Estimates Project

Primary Financial Statements Project

Goodwill and Impairment/Business Combinations Project

IFRS for SMEs Project

Management Commentary Project

**International Audit and Assurance Standards Board (IAASB)**

Quality Management at Firm Level – ISQM 1

Engagement Quality Reviews – ISQM 2

Quality Management at Engagement Level – ISA 220

Extended External Reporting (EER) Assurance

ISA 315 (Revised) on Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

ISA 600 on Group Audits

Audits of Less Complex Entities

**International Ethics Standards Board for Accountants (IESBA)**

International Code of Ethics for Professional Accountants – revision

**International Forum of Independent Audit Regulators (IFIAR)**

Annual Inspection Findings Survey

**International Organisation of Securities Commissions (IOSCO)**

Report on Good Practices for Audit Committees in Supporting Audit Quality

**Monitoring Group**

Review of the governance of international audit-related standard-setting boards

**Public Company Accounting Oversight Board (PCAOB)**

Amendments to Auditing Standards for Auditor's Use of the Work of Specialists

Auditing Standard for Auditing Accounting Estimates, Including Fair Value Measurements

**Stichting Autoriteit Financiële Markten (AFM)**

Vulnerabilities in the structure of the audit sector

**Sustainability Accounting Standards Board (SASB)**

Human Capital Research Project

Conceptual Framework Project

**Task Force on Climate-Related Financial Disclosures (TCFD)**

TCFD Status Report

There are also multiple initiatives from individual audit firms and accountancy professional bodies of which we are aware but that we have not sought to capture here.

## Appendix 6 – Extract from Professor Andrew Likierman’s submission on professional judgment

After discussions with a wide range of people in all walks of life and in many different countries, including several professions, bearing in mind research in a number of different literatures, I suggest that professional judgement has 6 elements:

### **(i) What I take in**

This is a measure of the quality of understanding. In audit, as in other professional activities, the quality of what is understood is critical to developing a professional judgement. This does not necessarily improve with greater seniority and knowledge – impatience, overconfidence and any increasing rigidity of approach may reduce the quality of what is taken in.

### **(ii) Who and what I trust**

A great deal of work is carried out in teams and members of teams are likely to have experience in knowing who is trustworthy. Issues can nevertheless arise, for example if teams are chosen which have, or come to, reflect the point of view of a dominant team leader. Trust in the information is less predictable, particularly in a new client or assignment.

### **(iii) What I know about this**

For audit clients struggling to make sense of situations that they have not encountered before, rich professional experience is a great source of value. But professional knowledge is not enough – it is knowing about the issue in context. The quality of professional judgement will be the way in which relevant experience can be brought to bear in a given situation.

### **(iv) How I feel about this**

Professional judgement assumes that the professional will be able to be independent and unbiased. But this status cannot be assumed unless the professional is aware of his or her own biases, including risk tolerance or appetite.

### **(v) How I choose**

The combination of experience, knowledge and personal qualities comes together to formulate choices. The professional will need to ensure that the choices have been appropriately framed, including the management of risk.

**(vi) How I carry it out**

The professional carrying through a recommendation will have gathered experience on many aspects of execution, but he or she will need to be aware of execution issues, including the management of risk.

# Appendix 7 – Public Interest Entities (PIEs) director and statutory auditor public interest statements – a note for The Brydon Review: Dr. Carien van Mourik and Prof. Chris Humphrey

20 October 2019

Dear Sir Donald,

In a speech at the ICAEW on 4 October, you mentioned seeing part of the aims of your Review ‘as being both to consider how the quality of the existing audit product might be improved, and to explore whether and how audit should be defined in terms of its scope.’ You indicated that you ‘want to consider how audit can become a more informative process and product whilst not losing its compliance aspect.’

After a discussion on the future of audit on 7 October, Carien suggested that auditors could be required to include a public interest statement in the statutory Audit Opinion and to further elaborate on this point in the Audit Report. You asked Carien to draft a public interest statement within the next ten days or so. Carien then asked if she could ask Chris for help because combining what she knows about the public interest with what Chris knows about audit might be more productive.

Discussions with Chris led to a consideration of what it means to be a Public Interest Entity (PIE) and how a reformed audit function could improve the ways and processes by which PIEs function and are held to account. We asked ourselves what statements of intent and purpose should be expected of PIEs and what auditors should be doing with regard to such declarations, activities and endeavours. Further reflection and investigation quickly highlighted that the formal specifications of the public interested nature of PIEs is both sparse (in the literature) and limited (in the law). We think that Public Interest Statement of PIE directors and PIE auditors potentially offer an interesting, and justifiable, route for enhancing both the corporate reporting and auditing functions associated with such entities. In the process, this might open up the possibility of institutional reform that could both lend conceptual clarity and operational robustness to the reporting by PIEs and the auditing of PIE corporate reporting.

The proposals below tie in with on-going debates and reflections on the role of capitalism (and shareholder vs stakeholder led approaches to corporate governance). Our suggestions work within existing governance and regulatory structures by subjecting them to a questioning regarding the conceptual nature, delineation and operationalisation of the ‘public interest’ of PIEs.



Our suggestions for making audit more informative and maintaining its compliance aspect focus on improving the statutory audit of Public Interest Entities (PIEs) and redefining the scope of the audit as follows.

- The directors of PIEs should set out in a Public Interest Statement in the Directors' Report how they view the company's legal, financial, social and environmental responsibilities to the public interest. It would then also explain how the PIE has discharged its self-declared public interest obligations and responsibilities, what actions the PIE has taken to mitigate any externalities it has caused during the period, and how effective these actions have been.
- For the external auditor's Audit Opinion to include a statement indicating the extent to which the audit has yielded sufficient evidence of consistency between the content of the Public Interest Statement and the Directors' Report on the one hand, and the business model, the effectiveness of the internal controls, the ethical infrastructure, the financial statements and certain relevant elements of the Sustainability Report on the other hand. The auditors would need to state that, in their opinion and based on the evidence reviewed, the directors' Public Interest Statement is true, honest and fair.
- For the external auditor's Audit Report to include a statement that the auditors have acted, in intention and effect, in accordance with their commitment to serving the public interest over their personal and their employer's private interests. The Audit Report would need to report on the activities undertaken to collect the evidence, any challenges encountered in the process, and how these challenges have been dealt with.

In addition, we believe that the audit committee of PIEs should be renamed 'Public Interest Audit Committee' and reconstituted to ensure that its members reflect the public interest as defined by the directors in their Public Interest Statement in the Directors' Report.

In the note below, we will elaborate on the above four suggestions as follows.

1. Section 1 explains our focus on PIEs and possible changes required for PIEs.
2. Section 2 presents a draft Public Interest Statement and discusses related disclosures by the PIE's directors.
3. Section 3 provides a draft PIE External Auditors' Public Interest Statement to be included in the Audit Opinion, and some more detail on the external auditors' Audit Opinion on the PIE's directors' Public Interest Statement.
4. Section 4 briefly introduces the idea of a PIE Public Interest Audit Committee.

Thank you very much for giving us the opportunity to present our ideas to you.

Yours Truly,

**Carien van Mourik and Chris Humphrey**

## Focus on PIEs and the statutory audit of PIEs

According to the Brydon Review's Terms of Reference document, 'The Review is intended to take a fresh look at the scope of the audit, how far it can and should evolve to meet the needs of users of accounts, what other forms of assurance might need to be developed, and to define and manage any residual expectations gap. (...) It will consider how the audit product should be developed to serve the public interest in future, taking account of changing business models, new technology and stronger public expectations.'

The Terms of Reference seem to imply:

- that the Brydon Review focuses on the statutory audit of the accounts of Public Interest Entities (PIEs) and other public and private limited companies that are required to have their financial statements audited by an external auditor or audit firm, and
- the assumption that by serving the interests of the users of externally audited accounts, the audit product also serves the (general) public interest.

'When the Cadbury Committee published its report in 1992, it identified the audit expectations gap as one of the major problems facing the auditing profession. It pointed out that public expectations of auditors were unrealistic and therefore damaging (...)' (Humphrey et al, 2014: 175). The fact that the expectations gap persists and may be widening, indicates that attempts to change public expectations have not worked. Instead, the gap may need to be narrowed by working to meet the public's expectations.

*Our take (1): In this note, we particularly focus on the statutory audit of PIE financial statements and annual reports because PIEs are supposed to serve the public interest, by definition. Furthermore, PIEs are the most significant group of entities required to have a statutory audit.*

The meaning of the term 'Public Interest Entity' in the UK is narrower than in more than half of the EU countries (Accountancy Europe, 2019: Table 1, pp. 2-3). Currently, in the UK, 'Public Interest Entity' means:

- a. an issuer whose transferable securities are admitted to trading on a regulated market;
- b. a credit institution within the meaning given by Article 4(1)(1) of Regulation (EU) No. 575/2013 of the European Parliament and of the Council (d), other than one listed in Article 2 of Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and investment firms(e); and
- c. an insurance undertaking within the meaning given by Article 2(1) of Council Directive 1991/674/EEC of the European Parliament and of the Council on the annual accounts and consolidated accounts of insurance undertakings.

The UK could also decide that PIEs should include other designated entities as well, for example 'undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees.' (Accountancy Europe, 2019: 1). Think, for example, of the BHS employees who lost their employment as well as their pensions, or in the Carillion case where the government will have to pay the cost for the lack of performance. If Accountancy Europe's 2019 survey is correct, there are some 1,750 UK PIEs, about 1,700 of which are listed companies.

Of concern is the fact that the number of public limited companies and the number of listed companies is on the decline. It is possible that boards of directors decide to go private in order to circumvent stricter capital market rules and audit requirements. However, as mentioned

above, even large private limited companies can do substantial social damage. Therefore, the scope of PIEs in UK law may need to be widened. The term Public Interest Entity and the public interest that PIEs are thought to serve may need to be clarified.

*Our take (2): To date, specifications on what is required from a public interest entity have focused on legal obligations, for example regarding governance appointments. However, an in-depth look at the scope of PIEs in the UK and how being a PIE impacts on corporate strategy, values, and social and environmental responsibilities, could be useful in relation to statutory audit and the role of the audit committee.*

Historically, the corporate legal form had a social purpose. Early corporations had to be involved in public works to be granted limited liability (Micklethwait and Wooldridge, 2003: 46). The free tradability of shares initially served to entice more investors to become shareholders in companies engaging in expensive infrastructure-related ventures. Over time, different perspectives on corporations developed.

Some consider ‘the corporation a private creation to be governed by the private law of contract (Dine, 2001: 13) with no other purpose than increasing the wealth of its owners (Post *et al*, 2002: 8).’ (van Mourik, 2014: 56). Others consider the company an institution in its own right, that needs to take an enlightened shareholder perspective and engage in stakeholder management to survive. The Corporate Report by the Accounting Standards Steering Committee in 1975, held that ‘every economic entity whose format or size renders it significant’ has an obligation to publicly report (ASSC, 1975: 15) and be accountable to its stakeholders including the general public. What might be termed ‘the social perspective’ regards companies as institutions in their own right that must be held accountable for the value they create for financial stakeholders and benefits they create for other stakeholders as well as the externalities they cause to third parties, including the general public.

A single focus on financial performance encourages diverting financial, human, natural and other resources away from productive activity with higher social returns towards activities with higher private returns (Shleifer and Vishny, 1998: 56-57). Another is that the financial focus of corporate reporting does not encourage economic decision-making with a view to balancing economic, social and ecological sustainability.

*Our take (3): It would be logical for PIEs, who by definition are expected to act and report in the public interest, publicly to state the organisation’s interpretation of the public interest in relation to its strategy and operations, and for the directors to provide accountability for the PIEs intentions, actions and outcomes in the Directors’ Report. Furthermore, including financial reporting and, to a certain extent, non-financial reporting in the scope of corporate reporting and statutory audit requirements would enable a more balanced assessment of the financial, social and environmental sustainability of PIEs.*

Historically, the accounting profession (especially auditors) in the UK and the US were granted autonomy and self-regulation because of their commitment to serving the public interest over their own and/or their employer’s private interests (Schroeder *et al*, 2001: 527).

*Our take (4): Publicly stating the commitment to serving the public interest over their own and/or their employer’s private interests should make auditors mindful of their role and responsibilities as guardians of the public trust in capital markets and the corporate system.*

## Public Interest Statement in the Directors' Report

A. As the directors of a Public Interest Entity, we view our legal, financial, social and environmental responsibilities to the public interest as follows.

*This part can refer to:*

- *The mission/objectives of the entity;*
- *The entity's view of its obligations to all the different stakeholders such as customers, suppliers, employees, shareholders, investors, lenders, the government, local communities, or the general public;*
- *The risks and potential benefits of the business model for the PIE's stakeholders; and*
- *How the PIE has shaped its internal controls and ethical infrastructure to safeguard the public interest as self-declared.*

B. In pursuing our strategic, operational and financial business objectives, this year:

when the interests of ... and ... were in conflict, we decided on the following actions... Our Sustainability Report sets out our assessment of the social benefits and costs, and the environmental benefits and damage our actions and policies have caused (indicate pages).

C. We seek to mitigate the social costs and environmental damage caused to third parties and the general public. Our Sustainability Report also sets out the ways in which we seek to address the social costs and environmental damage caused by our business model and weaknesses in our internal controls and ethical infrastructure (indicate pages).

### Background and explanation

The idea is that that the Directors' Report or Statement of Directors' Responsibilities in Respect of the Annual Report and Financial Statements of PIEs include a section on:

- how the directors view their particular PIE's obligations and responsibilities to their different stakeholders, including the general public (possibly referring to the PIE's commitment to the UN Sustainable Development Goals and performance on the KPIs as set out in their Sustainability report);
- explain how the PIE has discharged its self-declared public interest obligations and responsibilities; and
- how the PIE has taken action to mitigate the externalities it caused during the period.

The information on these three points is auditable.

Many companies now subscribe to the UN Sustainable Development Goals (UN SDGs) and report on their KPIs in their Sustainability Reports. Companies who have committed to the UN SDGs should describe this commitment and the progress in respect of their KPIs in their Public Interest Statement. Unfortunately, many companies use their Sustainability Reports and refer to the UN SGDs to engage in impression management

The transparency and independent audit of the Public Interest Statement and the supporting explanation of the benefits and, particularly, the costs caused to third parties should make directors of PIEs accountable for, and mindful about, the truth, fairness, completeness and substance of their public interest claims.

If a Public Interest Statement by directors of PIEs in their Directors' Report is made mandatory, the statutory auditors are in a good position to assess the integrity of the Public Interest Statement, as well as the ethical values and ethical infrastructure of the PIE. According to Martin (2007: 8), the ethical infrastructure of an organisation comprises 'the formal systems, the informal systems, and the organizational climates that support the infrastructure. The formal and informal systems each include communication, surveillance, and sanctioning components.'

Because the PIE's stakeholders may comment on the content of the Public Interest Statement, this could generate a discussion with the company's management on what the 'public interest' should mean.

## Public Interest Statements in the Audit Opinion and the Audit Report

### In the Audit Opinion

In carrying out the audit of (insert name), a public interest entity, we have found sufficient evidence of consistency between the content and spirit of the Public Interest Statement in the Directors' Report, the business model, the effectiveness of the internal controls and the ethical infrastructure to underpin the Public Interest Statement, and the financial statements. In our opinion, the Public Interest Statement of (insert names) directors of (insert name of the PIE) is true, honest and fair (without qualification / with some qualification / with severe qualification).

### In the Audit Report

In carrying out the audit of (insert name of the PIE), a public interest entity, we have acted in intention and effect in accordance with our commitment to serving the public interest over our own (insert the names of the audit team) and our employer's (insert name of the audit firm) private interests.

Our processes and activities to find the evidence on the consistency between the content of the Public Interest Statement in the Directors' Report, the business model, the effectiveness of the internal controls and the ethical infrastructure in achieving company's (legal, financial, social and environmental) responsibilities to the public interest included the following....

The evidence we found included the following....

### Background and explanation

It is easy to confuse the 'public interest' with the 'common good'. The common good includes everyone, is objectively beneficial and the benefits are shared (Douglass, 1980: 104). The public interest is not one concept because it is tied to different ways of aggregating the private interests of individuals. Public interest claims are often used to justify policies or actions that benefit only a sub-group of the public. The Public Interest Statement by the external auditors will help users of the corporate reports to assess the extent to which they think they can rely on the information provided by the PIE and the integrity of the statutory audit.

In the US, statutory auditors must evaluate the effectiveness of the PIE's internal controls in relation to financial reporting as well as business objectives. Auditors could be required to 'consider the integrity and ethical values of management and employees' (Martin, 2007: 7) as part of the assessment of internal controls in respect of their safeguarding the public interest commitments as expressed in the PIE directors' Public Interest Statement.

## Each PIE needs a Public Interest Audit Committee

Our final suggestion is to change the title and function of the audit committee of a PIE into that of a 'Public Interest Audit Committee'. This committee would need to include, in addition to the function of the audit committee, the responsibilities for the effectiveness of the PIE's internal controls and ethical infrastructure to ensure that the PIE adheres to its own self-declared view of the PIE's legal, financial, social and environmental responsibilities to the public interest.

The Audit Committee would need to be reconstituted to ensure that its members reflect the public interest as defined by the directors in their Public Interest Statement in the Directors' Report. For example, if the directors state that their employees are included in the PIE's public interest mission, the Public Interest Audit Committee may need to include a representative of that group.

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## Appendix 8 – List of acronyms used in this report

**ACCA** – Association of Chartered Certified Accountants

**ACCIF** – Audit Committee Chairs' Independent Forum

**AFM** – Dutch Authority for the Financial Markets

**AGM** – Annual General Meeting

**AI** – Artificial Intelligence

**AICPA** – American Institute of Certified Public Accountants

**APB** – Auditing Practices Board

**APM** – Alternative Performance Measure

**AQR** – Audit Quality Review by the FRC

**ARGA** – Audit, Reporting and Governance Authority

**AURB** – Audit Users Review Board

**BEIS** – Department of Business, Energy and Industrial Strategy

**CA06** – Companies Act 2006

**CAI** – Chartered Accountants Ireland

**CAM** – US Critical Audit Matter

**CFA** Society of the UK – UK arm of the CFA Institute

**CFAI or CFA Institute** – global body for Chartered Financial Analyst designation

**CGU** – Cash Generating Unit

**CIIA** – Chartered Institute of Internal Auditors

**CISI** – Chartered Institute for Securities & Investment

**CMA** – Competition and Markets Authority

**COSO** – Committee of Sponsoring Organisations of the US Treadway Commission

**CPA** – Certified Public Accountant

**CPD** – Continuing Professional Development

**CRIRSCO** – Committee for Mineral Reserves International Reporting Standards

**DTR** – Disclosure Guidance and Transparency Rules

**EBIT** – Earnings Before Interest and Tax

**EBITDA** – Earnings Before Interest, Tax, Depreciation and Amortisation

**EER** – Extended External Reporting

**EFRAG** – European Financial Reporting Advisory Group

**ESG** – Environmental, Social and Governance

**ESMA** – European Securities and Markets Authority

**FCA** – Financial Conduct Authority

**FRC** – Financial Reporting Council

**GAAP** – Generally Accepted Accounting Principles

<b>GDPR</b> – General Data Protection Regulation	<b>JORC</b> – Australian Joint Ore Reserves Committee
<b>IA</b> – Investment Association	<b>KAM</b> – Key Audit Matter
<b>IAS</b> – International Accounting Standard	<b>KPI</b> – Key Performance Indicator
<b>IAASB</b> – International Auditing and Assurance Standards Board	<b>LLA</b> – Limitation of Liability Agreement
<b>IAESB</b> – International Accounting Education Standards Board	<b>LLP</b> – Limited Liability Partnership
<b>ICAEW</b> – Institute of Chartered Accountants of England and Wales	<b>MAR</b> – Market Abuse Regulations
<b>ICAS</b> – Institute of Chartered Accountants of Scotland	<b>P&amp;L</b> – Profit and Loss statement
<b>ICT</b> – Information and Communication Technologies	<b>PCAOB</b> – US Public Company Accounting Oversight Board
<b>IESBA</b> – International Ethics Standards Board for Accountants	<b>PIE</b> – Public Interest Entity
<b>IFIAR</b> – International Forum of Independent Audit Regulators	<b>PIS</b> – Public Interest Statement
<b>IFRS</b> – International Financial Reporting Standard, set by the IASB	<b>PPRD</b> – Payment Practices Reporting Duty
<b>IP</b> – Intellectual Property	<b>PRA</b> – Prudential Regulation Authority
<b>ISA</b> – International Standard on Auditing, set by the IAASB	<b>QCA</b> – Quoted Companies Alliance
<b>ISA (UK)</b> – International Standard on Auditing as adopted in the UK	<b>RNS</b> – Regulatory News Service
<b>ISACA</b> – Information Systems Audit and Control Association	<b>RWAs</b> – Risk-Weighted Assets
<b>ISQM</b> – International Standard on Quality Management, set by the IAASB	<b>SAT</b> – Indian Securities and Appellate Tribunal
<b>IOSCO</b> – International Organization of Securities Commissions	<b>SEBI</b> – Securities and Exchange Board of India
	<b>SEC</b> – US Securities and Exchange Commission
	<b>SOX</b> – US Sarbanes-Oxley Act
	<b>TCFD</b> – Task Force on Climate-Related Financial Disclosures

This glossary does not include commonly used acronyms for accountancy firms.



## Appendix 9 – A poem on auditing – taken from a 1951 edition of the Accounting Review

The poem reproduced below is taken from a 1951 edition of The Accounting Review. It is said to originate from the 1930s, and demonstrates how many of the same criticisms have been levelled against audit for more than 80 years:

### **The Accountant's Report**

We have audited the balance sheet and here is our report:

The cash is overstated, the cashier being short;  
The customers' receivables are very much past due,  
If there are any good ones there are very, very few;

The inventories are out of date and practically junk,  
And the method of their pricing is very largely bunk;  
According to our figures the enterprise is wrecked....  
But subject to these comments, the balance sheet's correct.

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